



Trimming the Sails

by Istvan Benczes

The Comparative
Political Economy
of Expansionary Fiscal
Consolidations

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**The Comparative Political Economy
of Expansionary Fiscal Consolidations**

A Hungarian Perspective

István Benczes



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E-mail: mgreenwald@sorosny.org

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To the memory of my father

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CHAPTER 1

Introduction

The theory and practice of fiscal policy has become one of the most often debated areas of research not just in modern macroeconomics, but also in political economy and political sciences. The fact that the state centralizes often half of the national income naturally indicates that fiscal policy exerts its direct and indirect influence in almost every segment of our lives. In principle, it can produce public goods, run state-owned companies, intervene in the future prospects of families through transfers or public wages, etc. By redistributing the national income, fiscal policy and those in charge of conducting it have an incredibly large responsibility in how individuals perceive their status in society.

Nevertheless, fiscal policy can also prove to be harmful in the hands of short-sighted political actors, who sacrifice the future in the hope of gaining some additional benefit in the short run. A misguided economic policy, resulting in serious overspending and skyrocketing debt ratios, however, forces leading politicians to embark on fiscal adjustment sooner or later. In principle, fiscal consolidation is undertaken in order to restore the macro financial conditions for a sustainable and long term economic growth. If the benevolent magician of economics textbooks existed, everything would be simple: our social planner would be willing to undertake the short-term burden of adjustment, knowing very well that the immediate costs will be fully compensated by the long-term benefits.

However, a benevolent social planner is not bound by those political constraints which make it rather troublesome for real-life politicians to implement a fiscal consolidation. Citizens (and especially interest groups), indeed, may attach more weight to the short-term costs than to the long-term benefits, thereby threatening the re-election chances of politicians. It is essential, therefore, for rational politicians to reap the benefits of any correction before the next election in order to stay in power—if they are willing at all to embark on fiscal retrenchment.

Typically, politicians are reluctant to implement restrictive measures; instead, they simply postpone them because of the expected opposition of voters. Certainly, fiscal retrenchment is not without economic and political costs—consequently, consolidation is always risky from a political point of view.

1.1 The puzzle: Expansionary fiscal consolidations

Seemingly, a widely shared consensus has evolved in the economic profession regarding the short-term and long-term consequences of fiscal adjustment: namely, that a *trade-off* exists between the short-term costs and the long-term benefits. Decisions regarding fiscal consolidation can, therefore, suffer from serious inaction and delay, which can further aggravate macroeconomic disequilibrium, undermining the future prospects for economic growth.

The experience of some countries in the last two decades, however, seem to defy the above consensus, giving rise to another stream of arguments, the concept of “expansionary fiscal consolidation” or “non-Keynesian effects” of fiscal policy. In the eighties, a large number of industrialized countries embarked on wide-scale adjustment programs in their general budget—targeting a reduction in the debt-to-GDP ratio and reducing the level of deficit financing. It came as a surprise that fiscal consolidation was not accompanied with the much-echoed side effect of economic slowdown, but instead (some) countries experienced a relatively quick recovery in economic activity, an immediate acceleration in economic growth. Giavazzi and Pagano (1990) were the very first to point out such unexpected outcomes in Denmark (1983–1984) and Ireland (1987–1989), sometimes referring to the phenomenon as the “perverse effects” of fiscal policy. Later on, several papers have been published, arguing that major fiscal consolidations proved to be expansionary in relatively large numbers in the last two decades. Giudice et al. (2003) for instance claimed that non-Keynesian effects are not that peculiar and rare within the European Union. The preparation for membership in the European Economic and Monetary Union induced the bulk majority of countries in the EU to commence on the consolidation of their general budget. Besides the two general references of Ireland and Denmark, the Netherlands, the UK and to a lesser extent Austria, Finland, Spain and Sweden also provided the earlier unexpected results, that is, fiscal consolidation culminated in accelerated economic growth in the short term.

Accordingly, Rodrigo de Rato (2004), the managing director of the IMF, has recently made the following simple but clear comment:

It may be, then, that the oft-cited conflict between the long term benefits of adjustment and its short-term costs does not always arise. In other words, it is possible to have what we call *expansionary fiscal contractions*.¹

Certainly, any stabilization measure entails costs. However, the rising popularity of non-Keynesian effects can be derived from the fact that they mean by definition an acceleration of economic growth even in the *short term*. That is, non-Keynesian effects refer to a surprising situation where the fiscal multiplier turns out to be negative: the indirect effects of fiscal impetus on private consumption and/or investment offset the direct effects of government action, thereby facilitating the implementation of fiscal consolidation. Accordingly, the book tries to provide some clues as to what determines such an unexpected outcome of a fiscal consolidation and what exactly should a government do in order for the country to experience expansionary effects. The study of non-Keynesian effects, therefore, justifies the application of both a positive and a normative approach.

1.2 Scope of the book

If it holds true that the longer-term benefits of fiscal adjustment are not in a trade-off with the short-term decline of output, life is indeed much easier than as it has been previously believed. From a purely *economic* point of view, the warm welcome of the perverse effects of fiscal policy can be explained by the apparent fact that in some instances fiscal retrenchment can end up in an expansion of economic activity even in the short run—a statement which sharply contradicts traditional Keynesian theory. However, one could go further in the argument and claim that based on the occurrence of non-Keynesian effects, fiscal adjustment can be made effectively costless for the politicians. With positive net gains at an aggregate level even in the short term, it would be easy to sell fiscal adjustment to voters without the government being threatened to be voted out from power at the following election—a *political economy* viewpoint.

¹ Speech delivered by Rodrigo de Rato, to the Real Academia de Doctores Barcelona, Spain, 25 November 2004. Emphasis as in the original.

However, certain questions arise in the light of both the economic and the political economy perspective.

- (i) If non-Keynesian effects are so attractive, why are governments still reluctant to embark on reducing the general government deficit, especially cutting the expenditures?
- (ii) And more importantly, why do only a few countries and only at certain times experience these effects, while others not at all?

Finding the proper answers to these questions means basically the identification of those circumstances and/or conditions under which a fiscal consolidation can boost economic activity even in the short term—making it appealing for politicians to undertake otherwise surely unpopular fiscal measures. Consequently, the aim of the book is to uncover the determining factors of a successful fiscal consolidation in terms of positive and accelerating economic growth.

Authors in the literature on non-Keynesian effects usually (and mostly unanimously) put the emphasis on the need for the devaluation of the national currency, the accommodating reaction of the monetary authority and favorable international economic conditions as the necessary accompanying tools of fiscal consolidations in order to realize the perverse effects (see especially Giavazzi and Pagano 1990 or Hagen et al. 2001). Some also add the necessity of large-scale adjustment, that is, size matters (Giavazzi, Jappelli and Pagano 2000); while others support the view that a high and increasing debt ratio (Blanchard 1990, Sutherland 1997 and Perotti 1999) or increasing government spending (Bertola and Drazen 1993), triggering an unavoidable adjustment, is the key to experiencing the expansionary effects of fiscal stabilization in the short term. Alesina and his company, on the other hand, place the emphasis on supply-side factors, such as the competitiveness and profitability of firms. A cut in government wages (or the level of public employment), they argue, makes it easier to lower the costs of labor in private companies, thereby gaining a more competitive position in the international markets and increasing economic output.²

However, as our critical assessment of the literature on non-Keynesian effects will reveal, certain institutional conditions are not included (or

² See especially Alesina and Ardagna (1998), Alesina, Perotti and Tavares (1998) and Alesina et al. (2002).

not as clearly) yet in the recommended “package” of conditions and factors which can facilitate the occurrence of the desired short-term effects. The ultimate aim is therefore to identify those necessary (albeit surely not sufficient) institutional conditions which can increase the likeliness of experiencing expansionary effects in the case of fiscal adjustment in the short term already.

Research on non-Keynesian effects can be divided basically into two streams: demand-side and supply-side explanations. By critically evaluating demand-side interpretations, it will be demonstrated that the importance of the lack of liquidity constraint and consequently the depth of financial intermediation has been generally neglected in the literature. By scrutinizing the supply-side rationalizations of non-Keynesian effects, it will be argued first that it is not the size alone what matters; instead, it is the composition of adjustment that can prove to be decisive in determining the sign of a fiscal multiplier. It will also be shown that a flexible labor market and/or a coordinated wage bargaining mechanism (especially in the form of a social pact) can strongly support the occurrence of expansionary effects in times of expenditure-based consolidations.

While Part One is an attempt to convincingly demonstrate the relevance of the above-mentioned institutional factors based on the critical assessment of the relevant literature and some European case studies and short data analyses, Part Two tests the identified institutional variables within the context of a specific country. Hungary has been selected for this specific purpose for two main reasons. This is the country in the EU (i) with the largest deficit at present (estimated at 10.1 per cent of the GDP in 2006), making Hungary one of the most vulnerable economies in the region; and (ii) the most in need to embark on a major fiscal consolidation without which there is no hope for the country to perform on its potential rate of economic growth. Nevertheless, the elaborated framework of the analysis is suitable for the scrutiny of any other country as well—this can be indeed one of the main assets of the book.³

Importantly, Hungary cannot opt out from introducing the single currency, the euro. Practically, what this means is that the country—

³ The international literature on non-Keynesian effects has analysed industrialized countries almost exclusively. Exceptions included Purfield (2003), Afonso et al. (2005) and Rzonca and Cizkowicz (2005), authors who, however, neglected the study of institutional conditions.

along with the other new member states—has to reduce its deficit and debt level to the Maastricht reference values of 3 and 60 per cent, respectively, in order to qualify for euro-zone membership and to abide by the rule of “close to balance or in surplus” fiscal position following EU-accession.⁴ The more the country waits with the introduction of the euro, the less benefits it can expect from having the single currency, since other new member states such as Slovakia or the Baltic states are now close enough to adopt the euro, making these countries more appealing for investment. Furthermore, independently from the changeover to the euro and the Maastricht numerology, the deteriorated fiscal performance seriously undermines the long-term sustainability of the Hungarian economy, devaluating substantially the potential growth rate of the country, estimated to be around 4.5 to 5.5 per cent annually (Erdős 2004).

As a corollary, Hungary has two options at the moment: either politicians realize the need for initiating fiscal adjustment or they take the position of wait-and-see. In the latter case, an exogenous shock will enforce the fiscal consolidation sooner or later, without providing any room for reducing the costs of adjustment. In the former case, however, there is still a chance to minimize the costs of the stabilization attempts or possibly to implement a consolidation with positive short-term growth effects. Since one of our main objectives is to identify those institutional conditions which are inevitable in experiencing non-Keynesian effects, our findings may hopefully contribute to the exploration of whether Hungary is ready at the moment to experience short-term expansionary effects. Certainly, if the conditions facilitate the emergence of non-Keynesian effects, it can give an incentive to politicians to continue with the consolidation of the general budget. In such a situation, political rationality (vote maximization) could coincide with economic rationality (maximizing society’s welfare).

Finally, it is worth clarifying that it is exclusively the *short-term* stabilization and its macroeconomic consequences, especially economic growth, that are investigated in the book. Accordingly, no medium or longer-term perspective of fiscal reform will be considered as relevant in the following chapters. Furthermore, the reaction of the monetary authority (inclusive of the exchange rate policy) or the role of the international economic environment will not be dealt either while dis-

⁴ See especially the Council Regulation no. 1467/97.

curring the short-term effects of fiscal retrenchment. Certainly, the full evaluation of a fiscal consolidation requires the assessment of both short and long-term consequences and the reaction of all the relevant agents. However, these issues have been widely discussed in the international literature; therefore it is not necessary to touch upon them here as well.

1.3 Why a comparative political economy approach?

The ultimate aim of the book is to understand why only a few countries and only at certain times experience non-Keynesian effects, while others not at all. That is, the ultimate interest is to explain cross-country differences, to uncover why some fiscal episodes proved to be expansionary, while others failed to deliver the short-term growth effects. A political economy approach seems to be the right choice for analysis, therefore, since it “has now emerged as an active and flourishing subdiscipline of economics, with the ambition of offering insights into the causes of the large cross-country differences in major economic outcomes and policies” (Acemoglu 2005:1).

The book indeed does not aim to develop new theoretical advances in the selected topic. Instead it tries to critically evaluate the already existing literature and also to expand the scope of study by elaborating on some institutional conditions of non-Keynesian effects that have been neglected more or less. Moreover, it also utilizes the advantages of qualitative case-studies by which the very specific circumstances of some European success stories can be hopefully identified. Accordingly, the term “comparative” has also been explicitly added to the title of this book.

Nowadays, it is more or less accepted in the economics profession that institutions, mechanisms and procedures can add to the understanding of the great variance in rational policy choice and economic performance among countries and in time. Comparative political economy (or CPE) is therefore the study of how the diverging economic, political, legal or social institutions can shape the choices of rational agents (such as politicians) and also their direct or indirect effect on economic outcomes such as deficit and debt. Since our focus is rather limited in this volume—expansionary fiscal consolidations—only those explicit and implicit institutions will be taken into account that can possibly facilitate the emergence of non-Keynesian effects. These

factors will be derived basically from two sources. On the one hand, a deductive analysis will direct our attention to the importance of financial markets, especially financial intermediation and credit markets. On the other hand, a more empirics-based scrutiny, applying an inductive analysis, will put the composition of adjustment and the labor market structure in the focus of discussion.

Comparative political economy brings back real-world phenomena into academic analysis. The explanations and prescriptions provided by CPE—even if just indirectly—significantly help the work of economic policy makers and politicians responsible for allocating and redistributing power and public money. With the reappearance of political economy in research, Csaba (2002:51) claims that “issues such as political feasibility or coalition building are gaining relevance vis-à-vis traditional considerations of coherence or analytical simplicity.” In fact, this is exactly what we are looking for in the forthcoming chapters. It will be shown what conditions and factors may provide positive incentives for politicians to embark on fiscal consolidation.

Nevertheless, it must also be emphasized that comparative political economy is rather far from being a closed, fully fledged and coherent research program. It has been progressing day by day, attracting the attention of more and more scholars and students and enriching new theoretical and methodological concepts and approaches to the field. This book, therefore, is also an attempt to broaden the applicability of comparative political economy.

1.4 Sources and data

The concept of non-Keynesian effects is a rather new phenomenon, yet the literature on the issue has proliferated substantially in recent years. Articles were published generally in the form of working papers, written mostly by the staff of the IMF, the OECD, the ECB or the European Commission. In addition, the most respected journals, such as the *American Economic Review* or the *Quarterly Journal of Economics*, were ready to publish articles on the topic, which clearly indicates that the short-term perverse effects of fiscal consolidation has become part of the mainstream fields of interest of theoreticians and policy-makers.

The book embarks heavily on quantitative statistical analysis. The main sources of data have been the following: the *European Economy* (especially its statistical annex) published by the European Commis-

sion and the OECD's most recent *Economic Outlook*. Data and information on Hungary were collected from the OECD's country reports, the IMF's country reports, the European Commission's country assessments and the *Country Profile* and *Country Report*, both issued by the Economist Intelligence Unit.

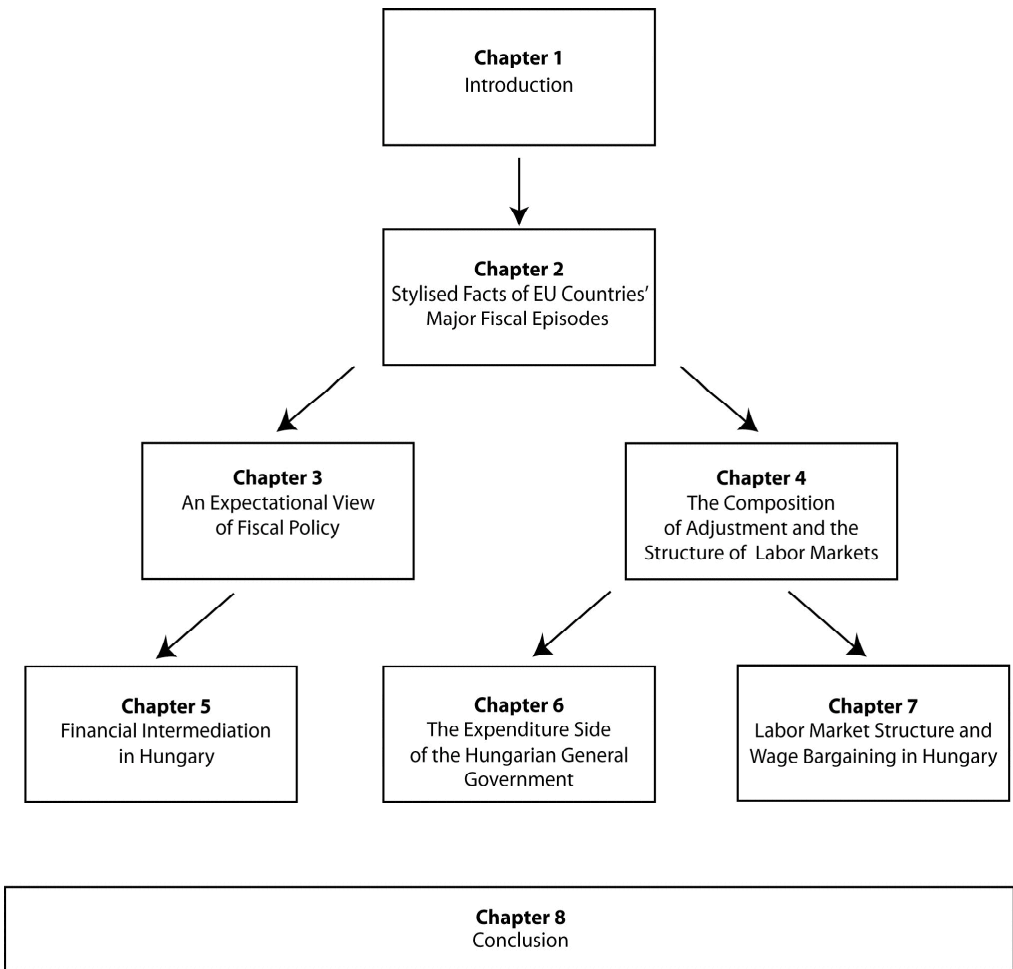
The collection of the relevant materials was completed in early 2006, therefore articles published after that date were not taken into consideration while working on the manuscript. More importantly, the latest data sets which were used in the book were published in 2005. Nevertheless, exceptions have been made in some cases, using data from 2006 (which will be indicated).

1.5 Structure of the book

Following the introduction, a short data analysis of Chapter 2 will show that non-Keynesian effects are indeed not that rare among European countries. This puzzle requires in turn an explanation. In the following two chapters of Part One, therefore, the relevant theoretical explanations are systematically and critically assessed and some empirical research—in the form of case studies and data analyses—will also be carried out in order to test the relevance of the theoretical rationalizations of non-Keynesian effects. Since explanations can be divided basically into two, first Chapter 3 looks at the various ways scholars—focusing on the demand side of non-Keynesian effects—have treated this issue with more or less success, and also delineates the possible way forward in the analysis of the unexpected short-term effects of consolidation. Emphasis will be on the so-called expectational view of fiscal policy, which attributes the emergence of expansionary effects of fiscal tightening to the concerns of private actors regarding the solvency of the state. Factors such as the size of the adjustment, the initial conditions, the prevalence of liquidity constraints and the depth of financial intermediation will be analyzed in length accordingly.

Chapter 4 turns to a different method of explaining the short-term expansionary effects of fiscal consolidation, focusing on the supply side of adjustment. The relevance of the fall of business cost, providing a positive supply shock in times of adjustment will be reflected upon in the chapter. Here, the importance of the composition of adjustment, the structure of the labor market and the system of wage bargaining will be elaborated on in detail.

After the thorough critical study of both the demand- and the supply-side explanations of non-Keynesian effects, Part Two turns to the investigation of Hungary and asks whether the previously identified conditions are present in the country in order to experience non-Keynesian effects in the case of fiscal tightening. Chapters 5–7 each concentrate on the specific institutional factors that have been identified earlier in Part One. Chapter 5 provides a detailed analysis of the country's financial intermediation system by showing that fiscal laxity strongly eroded liquidity constraint in the years of the new millennium. Chapter 6 is a comprehensive study of the expenditure side of the general budget, arguing that without a substantial cut in the public sector wage bill and household transfer there is absolutely no chance for either short-term expansionary effects or (and more importantly) a sustainable economic growth. Chapter 7 elaborates on the structure of the labor market and the wage bargaining system of Hungary, realizing that the current political and economic constellation is not suitable for the introduction and consolidation of a *social pact*, without which, however, it is rather unlikely that politicians will be brave enough to undertake the necessary restrictive measures. Chapter 8 summarizes the main findings. The structure of the book is displayed in Figure 1.1.

Figure 1.1 The structure of the book

CHAPTER 2

Stylized Facts of EU Countries' Major Fiscal Episodes

The theoretical and empirical studies on expansionary fiscal consolidation are relatively recent and accordingly the applied framework, concepts and methodologies vary substantially. In their most basic form, the empirical studies elaborating on the occurrence of non-Keynesian effects draw inferences from case studies. The main empirical evidences are then tested against a large sample of countries. Nevertheless, the main conclusions of the case studies should be considered with a critical mind since these results always refer to specific countries with specific situations in a given—usually exceptional—time.

According to the standard textbook approach,¹ fiscal consolidation has, by and large, two main macroeconomic consequences: the possible decline of the deficit and the debt-ratio; and sadly, economic slowdown. Apparently, there is a trade-off between stabilization and growth—a central idea of Keynesian macroeconomics. However, case studies have shown that in some instances the results do not follow the predictions of the textbook approach, that is, the trade-off may not exist under certain conditions. For instance, the macroeconomic consequences of the Irish consolidation in the eighties diverged evidently from the implications of the general theory.

Policy-makers who look at textbooks on their shelves to find out the effects of fiscal policy actions are increasingly puzzled. Real-life experiments tell surprising stories. For example, when in 1982 the Irish government introduced a very tight budget, private consumption plummeted. The ensuing recession induced a worsening of the budget that more than offset the initial discretionary tightening. Two years later both the deficit and the debt-GDP ratio were higher. Ireland tried

¹ Such as Gordon (1993) or Mankiw (2000a) for instance.

again in 1987. This time, however, output increased, amplifying the discretionary cut in the deficit, and the debt-to-GDP ratio fell substantially. Giavazzi (1995:240)

Consequently, international interest quickly turned to these *exceptional* episodes. Additionally, the unsustainable stance of public finances in some OECD countries in the eighties and early nineties, and the launch of the single currency in Europe gave an impetus to researches with a normative content, too. Eventually two (but to some extent overlapping) strands of research programs evolved over the last 15 years. Both concentrate on fiscal adjustments, however, a discernment based on the examined macroeconomic consequences of fiscal consolidation can be easily arrived at:

- (i) scholars who restrict their focus on the change (possibly reduction) in the debt-to-GDP ratio exclusively and call the reduction of the debt ratio as a “permanent” or “successful” adjustment;
- (ii) the other group which focuses on interpreting the change (possibly increase) in economic growth triggered by fiscal contraction—labeled as an “expansionary fiscal contraction” or a “non-Keynesian” fiscal episode.

In the studies conducted by the first group, the aim is to find some correlation between a fiscal episode and the *persistence* of the change in the debt-to-GDP ratio. Satisfying certain conditions, a fiscal adjustment is said to be permanent or successful if the debt ratio has been reduced significantly. While research on successful consolidations does not pay attention to other macroeconomic effects such as economic growth, the second stream of the literature targeted exactly this area and tried to find some correlation and possibly a casual link between fiscal contraction and economic expansion.

In this chapter, a simple descriptive data analysis will give some insights on the relevance of the main ideas of the literature. Instead of simply summarizing the main findings of the relevant literature, a short but detailed assessment on the fiscal adjustments of the EU countries and the effects of fiscal consolidation will follow. The data analysis focusing on fiscal aggregates and their macroeconomic consequences is comprised of the EU-14 countries (except Luxembourg) between 1980 and 2004.² The main objective of the chapter is, however, not to

replicate the data analysis conducted by others previously but to provide a clear-cut *puzzle* which may require special attention and explanation. The analysis consists of the following sections. First, we define and identify those fiscal episodes that were large enough to possibly exert some influence on real macroeconomic variables (section 2.1). In section 2.2, the effect of fiscal impulses on the debt-to-GDP ratio will be assessed. The economic output consequences of fiscal contraction will be tested in section 2.3. The data set, constructed in this chapter, will also help us to test empirically the relevance of theoretical explanations of non-Keynesian effects to be provided later on in Chapters 3 and 4.

2.1 Identifying exceptional fiscal episodes

The first step in our empirical analysis is the identification of so-called “exceptional” fiscal episodes. We need to separate these exceptional fiscal periods from normal times in order to grasp the systemic characteristics of exceptional cases. Exceptional fiscal episodes are defined as times when some measure of the balance of the general government experiences a significant change. Therefore, we need to focus on large adjustments exclusively, and leave the other observations with a relatively low or neutral impact out of the research. Admittedly, our descriptive statistical analysis turns to fiscal contractions exclusively, and does not scrutinize “large” fiscal laxities in depth—although in the literature, fiscal expansions are also studied in order to provide some counterfactuals.

Determinations of the term “exceptional”, however, vary substantially. Almost every paper applies a slightly different concept. A few definitions for the term are given in Table 2.1.

² The data were taken from two sources. Fiscal aggregates are excerpted from the Economic Outlook of the OECD (see OECD 2005a), while the data on economic growth were provided by the Statistical Annex of the European Economy, European Commission (1999 and 2005).

Table 2.1 Various definitions of “exceptional fiscal episodes” in the literature

Author(s)	Definition of “exceptional fiscal episode”	Coverage (countries and time span)
Afonso (2001)	A change in the primary structural balance by at least 1 standard deviation from the country average change over one year <i>or</i> an annual average change in the primary structural balance by at least one half of one standard deviation over two years.	15 EU countries, 1970–1999
Alesina & Ardagna (1998)	A change in the primary structural balance (using Blanchard (1990)’s method) by at least 2% points of GDP over one year <i>or</i> by at least 1.5% points of GDP in each year over two years.	20 OECD countries, 1960–1994
Alesina, Ardagna, Perotti & Schiantarelli (2002)	A change in the primary structural balance (using Blanchard (1990)’s method) by at least 2% points of GDP over one year <i>or</i> by at least 1.25% points of GDP on average over two years.	18 OECD countries, 1960–1996
Alesina & Perotti (1995)	A change in the primary structural balance by at least 1.5% points of GDP over one year <i>or</i> a change in the primary structural balance by at least 1 standard deviation from the country average change over one year.	20 OECD countries, 1960–1992
Alesina, Perotti & Tavares (1998)	A change in the primary structural balance by at least 1.5% points of GDP over one year.	19 OECD countries, 1960–1995
Giavazzi & Pagano (1995)	A cumulative change in the primary structural balance by at least 3, 4 and 5% points of GDP over two, three and four years (respectively) <i>or</i> 3% points change of potential GDP over one year.	19 OECD countries, 1970–1994
Giudice, Turrini & Weld (2003)	A change in the primary structural balance by at least 2% points of GDP over one year <i>or</i> by at least 1.5% points of GDP in each year over two years.	EU-14 countries, 1970–2002 (excluding Luxembourg)

Author(s)	Definition of “exceptional fiscal episode”	Coverage (countries and time span)
Hagen, Hughes-Hallett & Strauch (2001)	A change in the structural balance by at least 1.25% points of GDP over two years <i>or</i> by at least 1.5% points of GDP over one year plus by a positive amount in the consecutive year.	20 OECD countries, 1960–1998
McDermott & Westcott (1996)	A change in the primary structural balance by at least 1.5% points of GDP over two years and no decrease in any of the two years.	20 OECD countries, 1960–1994

Source: own construction.

The definition(s) of “exceptional fiscal episode” to be used in the book is the following:

Definition 1a: A year of fiscal episode (adjustment) in which the cyclically adjusted primary balance changes (improves) by at least 1.5 percentage points of the GDP.

Definition 1b: A period of two consecutive years in which the cyclically adjusted primary balance changes (improves) by at least 1.5 percentage points of the GDP in each year.³

In the selected empirical studies of Table 2.1, fiscal consolidation is always defined in terms of a given improvement in the specified form of fiscal balance over a given time period. Defining the measure of adjustment is always critical since the results may be sensitive to the chosen concept. Concerning the *size* of fiscal consolidation, a minimum of 1.5 percentage point improvement in the primary fiscal balance (in cyclically adjusted terms) is usually characterized as a very tight adjustment indeed which is not undertaken by governments too often. The norm in this specific literature is to define changes in the cyclically adjusted primary balance below ± 0.5 percentage point as neutral, while changes between ± 0.5 percentage point and ± 1.5

³ The events falling under the second—and stricter—definition can be viewed as *outstandingly* exceptional fiscal episodes. Certainly, a data point identified by *Definition 1b* is also a member of the wider group of episodes defined by *Definition 1a*, that is, episodes gathered under *Definition 1b* comprise a subset of *1a*.

(sometimes 2) percentage point as expansionary/tight. Above 1.5 (or sometimes 2) the change is said to be very expansionary or very tight. Nevertheless, the relatively high threshold applied in this study (a minimum of 1.5 percentage point improvement in the primary cyclically adjusted fiscal balance) enables us to select just a few, probably the most robust cases of adjustments. These may prove to be significant enough to induce changes in macroeconomic variables such as the debt-ratio or economic output. Moreover, the magnitude itself makes it difficult to achieve such an enormous consolidation by *one-off measures* exclusively—at least not too frequently.

As far as the specification of the balance is concerned, the OECD's cyclically adjusted (or structural) balance was chosen in order to filter out the effects of business cycles. With cyclically adjusted terms, the discretionary part of fiscal impetus can be detected. Since we can concentrate on and scrutinize those changes exclusively which are under the ultimate influence/authority of politicians, we can pinpoint the political preferences in the process of redistribution.⁴ The reason for concentrating on the primary balance is that interest payments are out of the direct competence of decision-makers in the annual budgeting process (although, it is sometimes exactly the large size (in GDP) of interest payment that triggers a change in the course of fiscal policy).⁵

The total number of annual observations in the EU-14 over the period of 1980 and 2004 is 350 (25×14), out of which 87 episodes were exceptional (both tightening and profligacy), based on our *Defini-*

⁴ Detecting the cyclical component in fiscal variables is not without controversies, however (see especially P. Kiss and Vadas 2005). Throughout this chapter, OECD measures are applied, which estimate the cyclical effects on the structural budget by applying a production function approach. Alesina and Ardagna (1998) and Alesina et al. (2002), on the other hand, found it more appropriate to follow the full employment budget balance concept of Blanchard (1990), while the studies conducted at the European Commission (see Giudice et al. 2003) usually apply a third technique, using HP filter.

⁵ One main deficiency of any measure of “large” adjustment is the occurrence of such temporary measures which do not have by definition an instant impact on the balance of public finances, nevertheless, they can strongly affect the actual data on fiscal balance. Such one-off measures—often coming in the form of creative accounting, which by definition cannot have any real macroeconomic effect—were used discretionally in a few EU countries just before 1997 for instance, in order to pass the necessary fiscal requirements for EMU-membership.

tion 1a (the major fiscal episodes can be found in Appendix 1). A relatively large portion, two-thirds of the events can be described as tight fiscal courses (58 cases). The much stricter alternative definition of exceptional (1b) allowed us to count a total of 14 episodes of extremely tight fiscal consolidations (a non-negligible subset of the 58 tight episodes). Interestingly, the number of observations of fiscal laxity in the same period lags significantly behind the adjustment-events with its total number of 29 episodes (by applying *Definition 1b*, this number shrinks surprisingly to only two (!), fiscal expansions experienced by Belgium in 1980 and 1981 and by Greece in 1988 and 1989). The remarkably low share of lax (and especially extremely lax) fiscal episodes can be rationalized if the time-span is taken into consideration. The recognition of the importance of sustainability in public finances evolved exactly in the eighties after decades of large overspendings; and preparation for the EMU got another impetus to the restraint from overspending in the nineties. In fact, other studies cover the period starting with 1960 or 1970 not simply in order to get a higher sample but because the wider cover of time allows them to identify more (indeed much more) cases of fiscal expansions as exceptional fiscal episodes. For a summary, see Table 2.2.

Table 2.2 Number of exceptional fiscal episodes by feature

	Adjustment	Expansion
Definition 1a	58	29
Definition 1b	14	2

Source: own calculations.

The fiscal episodes do show a concentration in a few countries, however. Ireland and Greece stand out from the field with the total observations of six adjustments plus three expansions in the former and six contractions plus six expansions in the latter. Portugal, Finland and Italy also provided a higher than average performance regarding the number of adjustments (all three of them had six events). On the other end of the spectrum France (1 adjustment and zero expansion), Germany (1, 2) and Spain (1, 1) can be found. Nevertheless, the low number of exceptional adjustment episodes does not mean necessarily the lack of fiscal discipline. In fact, the contrary may also be the case.

The absolute (or relative) number of adjustments is certainly not a good predictor of fiscal performance.

Concentrating on the time-distribution of exceptional fiscal episodes, Table 2.3 shows some unevenness, with a clear lead of the eighties (both contraction and expansion), while the new millennium—regarding adjustments—lags behind visibly. Comparing the eighties and nineties, the number of events can be an indication of the fact that the consolidation of public finances in the European Community was not simply a concern triggered by Maastricht. Countries in the eighties (well before the Maastricht numerology had been invented) already undertook wide scale adjustment programs. The unsustainability of public finances had become an important part of the economic and political agenda as early as the beginning of the eighties—indeed 9 out of the total 14 outstandingly tight adjustments (*Definition 1b*) were undertaken in that decade. Nevertheless, the spirit of Maastricht can be explicitly felt in an abstention from conducting expansionary fiscal policy during the nineties (15 lax episodes in the eighties versus 10 lax events in the nineties).

Table 2.3 Number of exceptional fiscal episodes
in the year they occurred

	Adjustment 1980s	Adjustment 1990s	Adjustment 2000–04	Expansion 1980s	Expansion 1990s	Expansion 2000–04
Definition 1a	31 (9)	23 (5)	4 (0)	15 (2)	10 (0)	4 (0)

Source: own calculations.

Remark: the subset of episodes according to *Definition 1b* can be found in parentheses.

2.2 Macroeconomic consequences I: Permanent consolidations

We now turn to the macroeconomic consequences of fiscal adjustment. First, it will be investigated whether the government initiated a long-lasting, that is, successful adjustment, for which a new concept needs to be introduced.

Definition 2: a fiscal adjustment in year t is permanent (or successful) if the gross debt-to-GDP ratio is at least 5 percentage points of the GDP lower in year $t+3$ than in year t .⁶

Table 2.4 indicates that less than one-third of the selected fiscal adjustments proved to be successful as it has been defined by *Definition 2*. That is, two-thirds of the attempts to consolidate public finances ended up without palpable results. (Data are provided in Appendix 2.) Our first conclusion of the data analysis is therefore the following: *not each and every fiscal contraction results in an improved stance of public finances*. It often turned out that failed attempts ended up in even larger debt ratios.

Table 2.4 Sample characteristics of fiscal adjustments I

	Total sample	Successful adjustment	Unsuccessful adjustment
Number of observations	57	17	40
Average size	2.44	2.30	2.50
Standard deviation	0.69	0.59	0.72
The highest value	5.23	4.51	5.23

Source: own calculations.

Remarks: The total number of adjustment events is one less than in Table 2.2 because Ireland (2003) cannot be taken into account in the further analysis, since the time period following the adjustment has not been long enough to assess the ultimate effect of the fiscal impulse.

In case of Greece, the data on debt was obtained from the European Commission (2005) because the OECD (2005a) data set had not yet contained the revisions initiated by the European Commission due to the earlier Greek practice of creative accounting.

Our second conclusion of the data analysis may be more interesting. Looking at the statistical characteristics of fiscal adjustments in Table 2.4, the conclusion can be stated as follows: *the main difference between successful and unsuccessful consolidations was not the magnitude of adjustment itself*, that is, the size of an adjustment cannot account alone for the success of any adjustment-trial. (In our study, unsuccessful adjustments on average were even more sizable than successful ones.) It is in fact bad news for those who think that concen-

⁶ The same definition for permanent adjustment was applied by Alesina and Perotti (1995) for instance.

trating on the size exclusively and disregarding other factors would bring the debt-to-GDP ratio down. Our result confirms what Alesina and Perotti (1995 and 1996) have also found in their seminal papers: the size of adjustment may not prove to be a good predictor concerning the success of any consolidation.

The threshold for being qualified as a *successful* adjustment was defined by a 5 percentage point decline in the debt ratio over a three year period. It was also checked, however, whether the 5 percentage point decline occurred earlier than three years. The results are surprising: only four cases out of the 17 episodes required three years to become successful, the rest provided a significant fall in the debt-to-GDP ratio within one or two years already. More impressively, in eight instances out of the total 17, the decline in debt over the three years was above 10 percentage points. Ireland produced a cumulated 36.5 percentage point decline between 1986 and 1992! However, probably, it is more interesting that the same country experienced a catastrophic fiscal consolidation in 1982–83, when the unsuccessful attempt ended up with a 38.4 percentage point total increase in the debt-to-GDP ratio by 1986. Not surprisingly, Ireland is the most popular subject of studies on the perverse effects of fiscal consolidations. The UK (1998–2001), the Netherlands (1996–1999) and Sweden twice (in 1986–1989 and 1996–1999) also experienced highly successful contractions. It is worth noticing, however, that neither the UK nor Sweden belongs to the single currency area, for these countries the ultimate reason for fiscal restructuring was not simply the fulfillment of the Maastricht numerology.⁷ On the other hand, countries such as Italy for instance provided a rather hectic performance during the nineties by struggling with reducing its debt-ratio. The first attempt proved to be a total failure. Although the fiscal deficit decreased substantially in 1993 and after, it was not enough to trigger an immediate decline in the debt ratio. In fact, the debt ratio increased between 1993 and 1996 by 11 percentage points. The negative trend was broken off only by the 1996–97 consolidation attempt, assuring Italy's position among the members of the euro-zone.

⁷ This phenomenon is an indication of the trend that fiscal consolidation is quite often a part of a broader reform program, refuting the opinion that the adjustments perceived in the nineties were mostly temporary or illusory.

2.3 Macroeconomic consequences II: Economic growth

The ultimate scope of the book lies in disseminating the conditions, circumstances and mechanisms under which it is likely to experience the occurrence of non-Keynesian effects. In this section, our aim is to quantify the number of fiscal episodes that might have proved to be non-Keynesian in the last two and a half decades. The task is therefore the identification of those episodes which experienced a fiscal contraction accompanied by an acceleration of economic growth. However, diverging interpretations arise with the concept of the expansionary effects of fiscal consolidation in the literature. Basically, expansion should mean an acceleration in economic activity during and/or after a fiscal impulse has been implemented. The basis for comparison can be the level of growth rate before the year(s) of adjustment or some benchmark growth rate such as that of the G-7 or the EU-15 (14) average. In the second case, the effects of the external forces (such as changes in the economic activity of the main trading partners) can be filtered out to some extent. The time-period over which the growth-effect is observed varies considerably, too, in the international literature.

Our definition(s) of “expansionary fiscal consolidation” is then the following:

Definition 3a: A fiscal contraction in year t is expansionary if the average real GDP growth rate during and after the adjustment, that is, in years t , $t+1$ and $t+2$, is above the average growth level of years $t-1$ and $t-2$.

Definition 3b: A fiscal contraction in year t is expansionary if the average difference between the real GDP growth rate of the country and the EU-15 growth rate during and after the adjustment (that is, in years t , $t+1$ and $t+2$) is above the average growth difference of years $t-1$ and $t-2$.

The results of the selection based on the two definitions of non-Keynesian effects are summarized in Table 2.5 (data are provided in Appendix 3). The first interesting observation that can be made is that *almost half of the consolidation attempts in the EU-14 between 1980 and 2004 were paired with an acceleration of economic activity*. This finding is supported by Giudice et al. (2003), too, who, although working in a different time-span (1970–2002) and with an alternative defi-

Table 2.5 Expansionary and permanent fiscal consolidations in the EU-14 (the year in which fiscal adjustment evolved)

	Expansionary <i>by Definition 3a</i>	Expansionary <i>by Definition 3b</i>	Permanent <i>by Definition 2</i>	Permanent & expansionary
Austria	1996, 1997	1996	—	—
Belgium	1984*, 1985	—	1993	—
Denmark	1983*, 1984*	1983, 1984*	1984, 1986, 1999	1984
Finland	1993*	1981*, 1984, 1993, 1998*	1998	1998
France	1996	—	—	—
Germany	1989*	1989*	—	—
Greece	1987, 1994*, 1996*	1996	—	—
Ireland	1987*, 1988*, 1989*	1982, 1983, 1987*, 1988*, 1989*	1987, 1988, 1989	1987, 1988, 1989
Italy	1983*, 1993	1983	1997	—
Netherlands	1993, 1996	1991, 1993, 1996*	1993, 1996	1993, 1996
Portugal	1986*, 1988,	1986*, 1988*,	1992	—
Spain	—	—	—	—
Sweden	1983*, 1987	1983, 1996	1986, 1987, 1996	1987, 1996
UK	1997, 1998	1996, 1997, 1998	1997, 1998	1997, 1998
<i>Number of total observations</i>	25 (13)	25 (11)	17	11 (8)

Source: own construction.

Remarks: *: the acceleration is larger than 1 percentage point of the GDP. Total number of marked data points (*) in brackets.

In the last column of the table (permanent and expansionary), the bold type means that both growth criteria have been met; the normal type refers to cases where only one type of growth criterion has been met.

dition for fiscal impulse, came to the same conclusion. Importantly, the apparently strong relationship between fiscal impulse and positive growth effect may not evidently be a causal one yet. Other factors may also contribute considerably (in some cases perhaps exclusively) to the growth-enhancing effect of fiscal consolidation. However, the fact that over 40 per cent of the total 57 observed adjustments proved to be expansionary cannot be neglected by any means. The numbers should

convince the reader that the general Keynesian understanding of fiscal consolidation, i.e. the view that fiscal contraction should *always* be followed by a slowdown in economic activity, is not supported by evidence from the EU. The high number of counter evidences strongly supports a rather different perception: in some instances the usual Keynesian rule-of-thumb does exist, but in some other instances not.

The relatively high proportion of episodes with expansionary effects is in itself a puzzling result that demands an explanation. However, when even the magnitudes are considered, the results become more perplexing. Studying the size of the triggering fiscal impulses (Table 2.6), the difference between fiscal consolidations with expansionary and contractionary growth effects is almost negligible—in fact, the size of adjustment in the case of contractionary consolidation is even larger, by almost 0.3 percentage point of the GDP. Thus, in general, *the size of adjustment once again proved not to be a precise predictor concerning the macroeconomic consequences of fiscal retrenchment.*

Table 2.6 Sample characteristics of fiscal adjustments II

	Total sample <i>Definition 3a</i>	Expansionary fiscal adjustment	Contractionary fiscal adjustment
Number of observations	57	25	32
Average size	2.44	2.28	2.57
Standard deviation	0.69	0.67	0.68
The highest value	5.23	5.23	5.00

Source: own calculations.

Table 2.5 also indicates a relatively high number of coincidence between permanent (debt-reductionist) and expansionary events in times of fiscal contractions: 9 out of 57 episodes satisfy both *Definitions 2* and *3a*. The surprising lesson from our sample of EU countries is that the likeliness of experiencing a permanent reduction in the debt-to-GDP ratio following a fiscal consolidation (17 out of 57) is evidently smaller than experiencing an acceleration in economic output (25 out of 57). It also shows, however, that the emergence of expansionary effects in the short-term does not necessarily imply sustainable public finances in the longer run. Although this book focuses on the short-term effects of fiscal consolidation, it needs to be admitted that it might be danger-

ous to concentrate exclusively on the short-term consequences of an adjustment since a sudden and *temporary* improvement of the primary balance cannot in fact restore long-term sustainability. Several countries, such as Austria, Belgium, Greece, Italy or Portugal experienced an acceleration of economic activity at times of adjustment, while their longer term effect did not verify the “appropriateness” of their fiscal restrictions later on.⁸

On the other hand, Belgium (1993), Italy (1997) and Sweden (1986) are examples of successful stabilization attempts (i.e. they have achieved a permanent reduction in their debt-to-GDP ratios), but were unable to experience the expansionary effects of fiscal consolidation. Presumably, for these countries the fundamental target was to hinder the further accumulation of debt, therefore the concentration was directed exclusively to the breaking off of the increasing trend of indebtedness.

The parallel occurrence of debt-reduction and (relative) growth-increase may prove to be important from our point of view because presumably the *pure effects* of fiscal consolidation could be assessed by this way since the significant and effective debt-reduction could be a good proxy for the change in the course of fiscal policy. Debt-reduction, together with expansionary effects following a fiscal consolidation, might become supportive to the hypothesis that fiscal policy is (one of) the ultimate source(s) of the occurrence of non-Keynesian effects, provided that the other variables have been controlled for.

Of course, there are several other methods for filtering out the pure effects of fiscal policy. Monetary easing for instance could largely support fiscal adjustment. Giudice et al. (2003), after having controlled for the effect of monetary policy, discovered that half of the non-Keynesian episodes they identified were achieved by fiscal policy exclusively. If the decrease in the debt-ratio is indeed a good predictor for the manifestation of the pure effects of fiscal policy, our statistical analysis has also shown that almost 40 per cent of the expansionary episodes can be possibly contributed to fiscal policy purely: 9 (*Definition 2 and 3a*) or 10 (*Definition 2 and 3b*) cases (the successful cases coinciding with the expansionary episodes) out of 25 expansionary episodes. These fiscal episodes were the following: Denmark (1984), Ireland (1987, 1988, 1989), the Netherlands (1993, 1996), the UK (1997, 1998) and to a lesser extent Sweden (1987).

⁸ In Chapter 4, we will turn our attention to the composition of adjustment, therefore.

2.4 Summary

The sample characteristics of our data set make it possible to draw some simple but clear inferences about the fiscal policy episodes in exceptional times. Basically, three major observations can be made in accordance with the findings of ours and the international literature:

- (i) Not every single fiscal consolidation results in improved public finances (that is, in a reduced debt-to-GDP ratio); in fact, a lasting debt-reduction is rather rare.
- (ii) Fiscal contraction is not always accompanied by an economic decline in the short run; in fact, there are some instances when economic activity does accelerate.
- (iii) The size of adjustment *alone* is not a good predictor concerning either the persistence or the expansionary effect of fiscal consolidation.

Certainly, the descriptive data analysis of exceptional fiscal episodes and their consequences presented above is not without doubts. Still, the large number of non-Keynesian fiscal contractions should make everyone to start thinking about it. It is true that there are serious methodological concerns, but the international comparative studies on the non-Keynesian effects of fiscal consolidation have one main point in common: *they almost all found some evidence* for the prevalence of expansionary effects in OECD countries. In the following chapters, therefore, we wish to understand the special mechanisms and conditions that enable policy-makers to undertake a fiscal consolidation, without the threat of being voted out of power, and thereby to reverse and delay reform until a crisis with serious short-term macroeconomic consequences compel the government to initiate costly changes in the previous fiscal course.

CHAPTER 3

An Expectational View of Fiscal Policy

A Non-Linear Approach to Fiscal Consolidation

Fiscal consolidation delivers benefits in the medium and especially the long term, thereby providing a sustainable path for economic development—a consensus view widely shared in the economic profession. This belief is reflected in the Maastricht Treaty of the European Community as well, for instance. By deepening the European integration process, the godfathers of the treaty declared, in Article 2 that the ultimate goal of Member States and the Community shall be to maintain an economic environment with sustainable and non-inflationary growth. The Stability and Growth Pact provided the details how this aim could be fulfilled, by requiring the governments to achieve a “close to balance or in surplus” fiscal position. While there is indeed a strong belief in the long-term positive consequences of fiscal adjustment, no such agreement has yet been reached regarding the short term effects. In fact, it is the costs of fiscal consolidation that has been emphasized in the literature: it seems that the longer-term benefits of fiscal adjustment can be achieved only at the expense of the short-term decline of output.

Nevertheless, critical opinions have been recently voiced regarding the necessity of such a trade-off over time. Some of the sceptics actually doubt the effectiveness of fiscal policy, claiming that the fiscal multiplier is much lower than 1; it can even be zero. Others, however, turn the whole Keynesian argument on the effectiveness of fiscal policy upside down and argue that the multiplier can easily change into negative in the short run. The main message of Chapter 2 was that almost half of the initiated major fiscal consolidations were implemented without experiencing the “necessary” decline in the aggregate demand. Importantly, Chapter 2 did not posit a causal relationship between fiscal consolidation and growth in the output of the EU-14 during 1980–2004 in the short run. It simply stated that there was a surpris-

ingly high share of attempts where no trade-off between fiscal adjustment and economic growth was found. The results are in line with other studies (such as Giudice et al. 2003, for instance) which claim that the lack of a drop in aggregate output in times of fiscal consolidation may not be that peculiar and rare. This puzzle, however, requires an explanation. Chapters 3 and 4 therefore attempt to systematically analyze the theoretical explanations of non-Keynesian effects. Nevertheless, it needs to be emphasized that the existence of non-Keynesian effects has not yet been unquestionably proven, albeit several attempts have been made in order to provide a comprehensive and universal theoretical explanation of the phenomenon. Various authors interpret non-Keynesian effects differently. It should not be surprising then that the conclusions are significantly sensitive to the applied framework of analysis and the explicit and/or implicit assumptions the models have been built upon.

Two main interpretations of non-Keynesian effects can be recognized in the relevant international literature: the demand-side approaches (or the expectational view of fiscal policy) and the supply-side rationalizations. Chapter 3 will focus exclusively on the demand-side approaches, which can be considered as a clear attempt to provide a new and theoretically appealing explanation for non-Keynesian effects. The expectational view claims that the acceleration of economic growth in times of fiscal contraction is triggered by the changing behavior of rational, forward-looking private consumers. Following the short description of the Keynesian view in section 3.1, the chapter will first explore the basic tenets and the mechanism of the expectational view and provides a short assessment of the theory's empirical relevance in section 3.2. In passing, a scrutiny of modern consumption theory will highlight the importance of the underlying assumptions of the expectational view, placing the liquidity constraint and the depth of financial intermediation in the centre of analysis (in sections 3.3 and 3.4).

3.1 The traditional Keynesian view

According to the conventional Keynesian view of fiscal policy, aggregate demand can be effectively influenced in the short term.¹ The well-known assumptions of sticky prices and wages, under-utilized capaci-

¹ See for instance Gordon (1993) or Mankiw (2000a).

ties and given expectations about future investment form the basic elements of the standard Keynesian theory. In the presence of these assumptions, the government is able to use the tools of fiscal policy in achieving macroeconomic stabilization; thereby cushioning the adverse effects of business cycles. The mechanism of fiscal expansion is largely dependent on the working of a fiscal multiplier which amplifies government-induced changes in spending or taxation—albeit the spending multiplier is always larger than the tax multiplier. By inducing a change in private consumption, fiscal expansion will exert a more than proportional impact on output, providing a multiplier above 1. In the hope of the evolving leverage effect, the Keynesian view of fiscal policy supports the active use of discretionary measures besides the automatic stabilisers, since the latter may not prove to be enough to counterbalance the negative output consequences of a declined demand in bad times.²

However, boosting economic activity by increased government spending is not without its drawbacks. Expansionary fiscal policy induces the interest rate to increase, causing (sometimes serious) crowding-out of private demand, thereby reducing interest rate-sensitive spending, especially private investment. Naturally, such a negative impact can be prevented by the accommodating monetary policy in a closed economy. If the monetary authority is willing to increase money supply in order to prevent a rise in the interest rate, the crowding-out effect may be zero. However, the magnitude of the fiscal multiplier largely depends on factors, such as the openness of the economy, the applied exchange rate regime and the degree of liberalization of capital accounts. The implications of the simple IS-LM model of a closed economy will change substantially in open macroeconomics—as it has been shown by Mundell and Flemming.³ These intervening factors can reduce the size of the fiscal multiplier and dampen the effectiveness of fiscal stimuli significantly. Assuming totally flexible exchange rates and perfect capital mobility would imply for instance the ineffectiveness of fiscal stimulus. In principle, the fiscal multiplier can be substantially

² Originally, the Keynesian anti-cyclical policy also meant that in good times governments should automatically give up deficit-financing and instead accumulate surplus in primary balance in order to provide buffers for bad times.

³ See especially Mundell (1968).

reduced below 1, even to zero, but it never turns into negative, that is, it can never change sign in a Keynesian perspective. In this view, the correlation between government spending and private consumption is in fact always positive, albeit the size is debatable.⁴

3.2 The concept of a negative fiscal multiplier

The effectiveness of fiscal policy can be undermined significantly if price flexibility, the full utilization of capacities, a lack of wasteful government spending activities and open economic structures are assumed. However, the concept of non-Keynesian effects goes beyond this and argues that the overall fiscal multiplier can turn into negative. The phenomenon is usually applied within the context of fiscal adjustment and refers to the unexpected *short-term* effects of fiscal corrections. The following definition can be introduced accordingly: non-Keynesian fiscal consolidation occurs if the ultimate short-term consequence of fiscal adjustment is an increase in economic output.

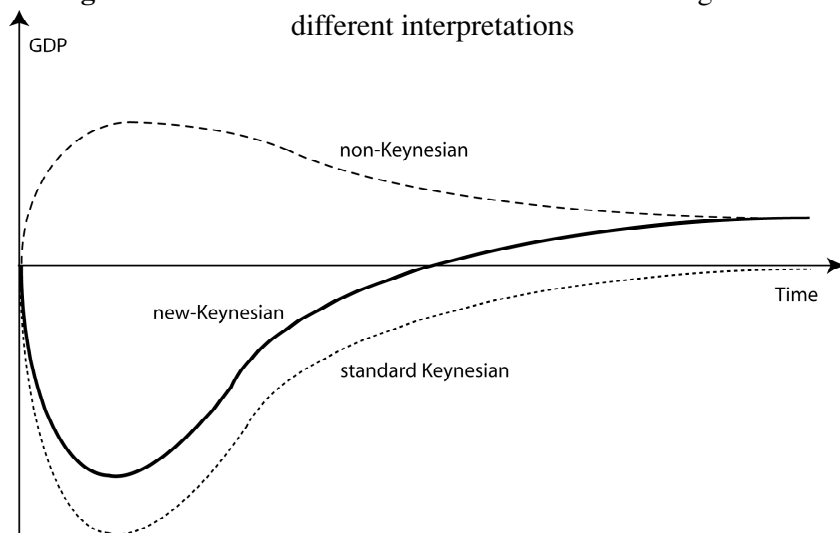
In a Keynesian world, assuming a positive fiscal multiplier, reduced government spending always has a double effect. A decline in public expenditure implies first a direct fall of aggregate demand; while the drop in private consumption through the multiplier effect—due to the decreased current disposable income—also adds to the decline of aggregate demand *indirectly*. The demand-side interpretation of non-Keynesian effects, however, claims that the second-round effects will be just the opposite of what the standard Keynesian theory suggests. The credible adjustment triggers an increase in the aggregate demand of individuals through an increased private consumption and/or investment. In other words, the decline in aggregate demand caused by increased taxes and/or reduced public spending is outweighed by the positive demand reaction of private agents.

Following Horváth et al. (2006), three different interpretations of fiscal adjustment can be seen in Figure 3.1. According to the *standard Keynesian models*, a positive multiplier prevails in both the short and the long term, that is, a consolidation is necessarily followed by a drop in aggregate demand. Adjustment can be unreasonably costly; thereby preventing politicians from embarking on fiscal consolidation. The *new-Keynesian* approach reflects a more consensus-based view. It makes a distinction between the short and the long-term consequences of fiscal

⁴ See the excellent survey of Hemming et al. (2002).

contraction, assuming a trade-off between the two. The short-term costs (providing a positive multiplier) can be compensated by the long-term benefits by the raised potential output. In such a situation the question is whether it is politically rational to undertake adjustment in the short run in the hope of the longer term benefits. A credible communication of the redistribution of net gains and the establishment of winning coalitions might be the necessary prerequisites for politicians to go ahead with corrective measures. It is worth emphasizing, nevertheless, that the short-term costs of fiscal contraction under this scenario can be lower (indeed much lower) than in the case of the standard Keynesian approach. Hogan (2004) argues, for instance, that private consumption may increase as a response to credible adjustment efforts, but the increase may not be sufficiently large to offset the drop of aggregate demand entirely. At the other extreme, in case of *non-Keynesian effects*, the overall negative multiplier emerges in the short run already, implying a full offsetting mechanism. Fiscal adjustment is practically costless from a macroeconomic point of view, making it not just rational, but also desirable for politicians to initiate the required fiscal measures. What can exactly justify the occurrence of the third, that is, non-Keynesian, outcome? In order to find an answer, those channels should be uncovered which may contribute—if at all—to the offsetting mechanism, changing the overall fiscal multiplier into negative even in the short run.

Figure 3.1 The effect of fiscal consolidation according to three different interpretations



Source: Horváth et al. (2006:11).

It is hotly debated even in the demand-side literature what exactly can induce individuals to react differently from what the standard Keynesian model would imply. Well before the publication of the seminal paper of Giavazzi and Pagano (1990) on the successful Irish and Danish fiscal consolidations in the eighties, Feldstein (1982) had already pointed out that the credibility of fiscal adjustment can be crucial in changing privates' behavior, by signaling the government's willingness to give up the previously exerted lax policy and to follow sound macro finances instead. Credible fiscal adjustment may have a positive indirect effect on aggregate demand, thereby cushioning the direct negative consequences of a decreased public expenditure.

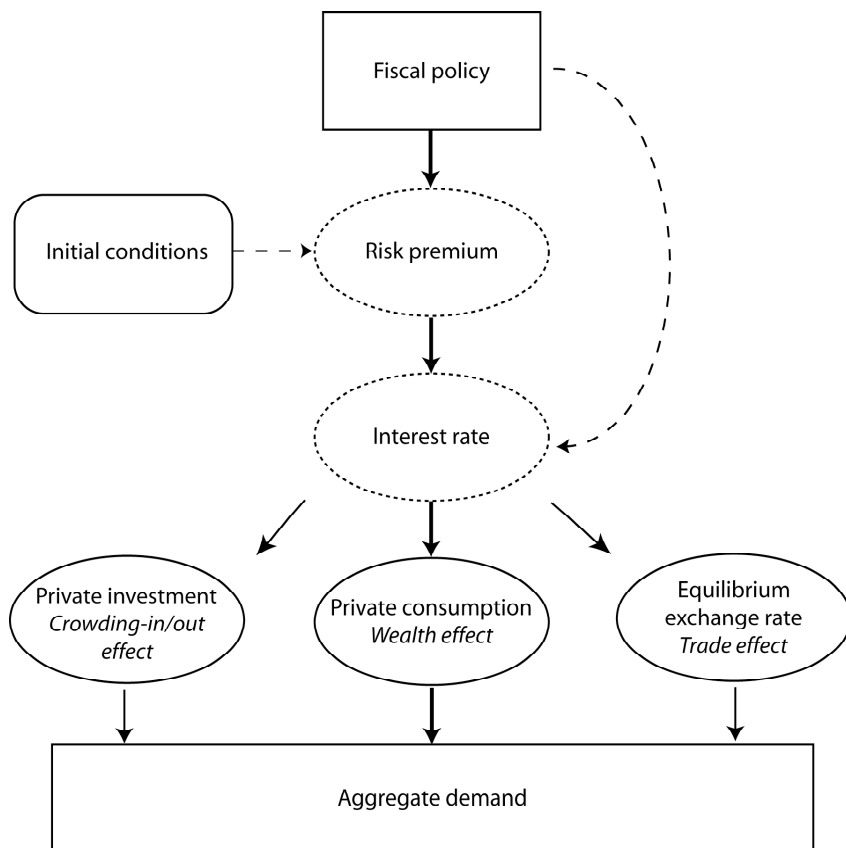
The credibility effect is strongly conditioned on the perceived change of the default risk of a country, and exerts basically its ultimate effect through two main channels. First, the reduced risk premia—triggered by credible fiscal consolidation—will reduce the interest rate in the economy, thereby crowding-in *private investment* and boosting aggregate demand. Second, the reduction in risk premia and interest rates would also revalue the nominal value of individuals' *financial assets*. The increased market value of the stock of wealth will in turn induce privates to spend more on consumption. This is the so-called wealth channel.⁵ The increased level of private investment and consumption can offset the negative effect of government expenditure cuts and/or tax increase on aggregate demand, thereby providing a chance for a reduced or even negative multiplier to emerge. Two further assumptions are, however, need to be mentioned. On the one hand, large adjustments are more likely to end up with a drop in risk premia as opposed to small-sized consolidations, because political commitment seems to be more explicit in the former case.⁶ On the other hand, private consumption can be expected to accelerate via the wealth channel only if households possess a positive (and significantly large) net wealth.⁷

⁵ Exchange rate devaluation has the same positive impact on consumption through the wealth effect if assets are denominated in foreign currencies.

⁶ The conviction that only committed, devoted and credible governments are able to implement successful and lasting adjustment (inducing positive reactions from the market by lowering the risk premium and by modifying expectations on private agents' wealth status upwards) can be dated back at least to the pioneering works of Kydland and Prescott (1977).

⁷ According to common sense, the credibility effect can be stronger if the debt-to-GDP ratio is higher. Hausmann (2004), however, convincingly documented

Figure 3.2 The effect of fiscal policy on aggregate demand I:
The general/standard interpretation(s)



Source: own construction.

A credible consolidation effort which successfully reduces risk premia and interest rates exerts an influence on the exchange rates as well. A drop in the interest rate causes the domestic currency to depre-

that a high initial debt-to-GDP ratio is not necessary in order for the credibility effect to appear. In fact, the low credit rationing and high risk premia of (some) emerging and transition countries cannot be accounted for with the size of indebtedness, but rather with the unhealthy *debt structure*. Emerging and transition countries issue debt instruments mainly in foreign currencies, on short maturity and with variable interest rates. The currency risk and the large volatility of interest rates make these countries, therefore, more vulnerable even in the case of a relatively low level of indebtedness.

ciate, thereby improving the trade balance of the country. However, the elimination of economic (and possibly political) uncertainty may have a different result as well, inducing the rate of exchange to appreciate, due to the inflow of capital as a response to the stable economic environment. The ultimate effect of stabilization is, therefore, not that evident—albeit the experience of small, open economies seem to verify the second, that is, the appreciation, scenario.⁸ (The above interpretations are summed up in Figure 3.2.)

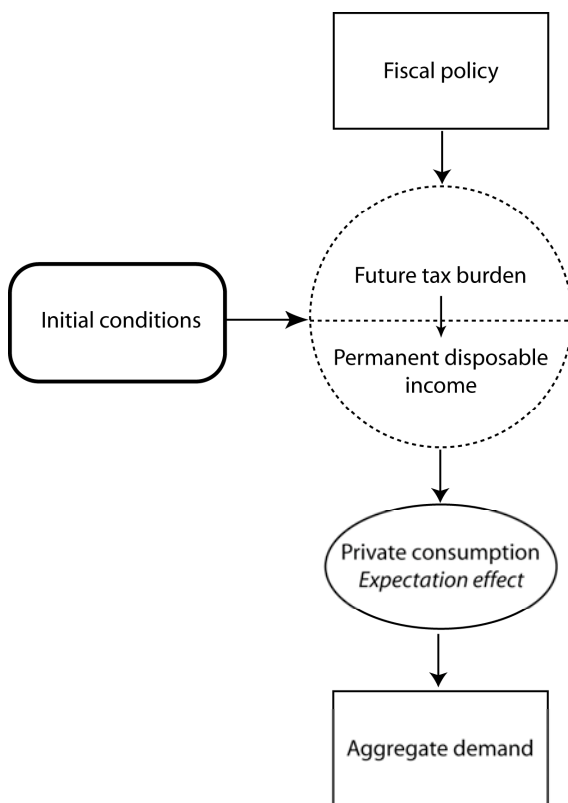
The recently emerging demand-side literature on non-Keynesian effects, however, identified another transmission mechanism by which the traditional Keynesian effects may be partly or fully offset. Not denying the relevance of the credibility effects, authors claim that fiscal policy affects not just the already accumulated wealth of individuals, but also their *prospective wealth status*. In more precise words, fiscal policy induces a change in the *expectation* of individuals regarding their permanent income. A successful fiscal correction may substantially improve the present value of expected future disposable income by reducing the future tax burden of rational and forward-looking individuals. The improved income (and wealth) prospects of individuals make it more appealing (and rational) to consume more today, thereby increasing the aggregate demand. The logic of the demand-side interpretation of non-Keynesian effects is displayed in Figure 3.3.

By focusing on the prospective wealth status, the expectations of individuals have become crucial in determining not just the size, but also the *sign* of the ultimate effect of fiscal policy. The expectational view assumes that individuals form and adjust their expectations rationally and in a forward-looking manner. The tool-kits of analysis are borrowed from modern, microeconomic-based macroeconomics. The concentration of authors on the optimization behavior of forward-looking agents reflects the latest tendencies of macroeconomics, which moved clearly towards the theory of rational expectations in the last few decades.

Accordingly, what remains to be clarified is what exactly can trigger a change in individuals' expectations. In a study on Ireland and Denmark, Giavazzi and Pagano (1990), claimed that it was the size of adjustment that delivered the change in the expectations of individuals. The authors argued that the larger the adjustment is, the more likely

⁸ Additionally, a successful and credible adjustment also reduces the value of interest payment, thereby implying a further improvement in fiscal balance.

Figure 3.3 The effect of fiscal policy on aggregate demand II:
A new approach



Source: own construction.

non-Keynesian effects occur. Five years later, on a larger sample, Giavazzi and Pagano (1995) tried to confirm their view once again and stated the following:

A cursory look at the data suggests that changes in the primary deficit, and particularly in government consumption, have non-monotonic effects on private demand. Cuts in government consumption and in the primary deficit of “normal” dimensions tend to be associated with a contraction of private demand, but when the change in government consumption or in the deficit becomes very large and/ or persistent, its correlation with private demand switches sign: a severe contraction tends to be associated with an increase in private demand, while abnormal budget expansions are correlated with private demand contractions. (Giavazzi and Pagano 1995:2)

According to the authors, the *signalling effect* of sizable fiscal consolidation, together with the credibility effect, were able to fully account for the prevalence of expansionary fiscal consolidations. Others, such as Blanchard (1990) for instance, turned however to the relevance of initial conditions, such as the debt-to-GDP ratio, as the determining factor of experiencing non-Keynesian effects. While quite a few followed this path, such as Sutherland (1997) or Perotti (1999); Bertola and Drazen (1993) studied instead the role of high and accelerating public spending as the factor that triggers a change in individuals' behavior. The role of initial conditions is easy to understand: the deteriorated economic situation calls for firm action from the side of government which may (or may not) change the expectations of individuals. At a (too) high level of debt or public spending, the state of public finances will deteriorate to such a degree that sooner or later a regime change will be enforced. In such a situation, every action which saves the economy from a final catastrophe may have indeed a positive growth effect.

In order to conceptualize the triggered change in expectations and private consumption, the expectational view has introduced the idea of the so-called *non-linear* demand effect of fiscal policy. According to this concept, nature has two faces: good (or normal) times and bad (or unusual) times. The reason for distinguishing between the two regimes is straightforward: expectations on the future tax burden must be different under different economic scenarios. Accordingly, non-linearity in demand means that while consumers follow a certain pattern in their behavior in most of the time (Keynesian for instance), there may arise certain conditions due to which consumers adopt a different behavior (Ricardian in our example). Such a switch can occur if the fiscal position of a country deteriorates into an unsustainable one. The unsustainable stance of fiscal policy in turn will trigger a change in individuals' perceptions on their permanent income. While in good times consumers behave as if they were Keynesians, a high level and/or accelerating debt or high and increasing public spending (the bad times) will induce individuals to turn their behavior into a Ricardian one. What this means in practice is that while in good times an increase in government spending would induce Keynesian consumers to increase consumption (positive multiplier), in bad times a further increase in government consumption will reduce the suddenly Ricardian consumers' appetite. That is, under this new scenario, any increase of public expenditure will cause privates to save more and reduce their consumption. A tax increase

will trigger the opposite effect: individuals would expect a higher permanent income and would therefore increase their consumption. It is in fact this switch or non-linearity in reactions which induces non-Keynesian effects to emerge, triggered by the observed change in the state of the economy and the credible fiscal adjustment.⁹

The two basic demand-side approaches of non-Keynesian effects—that is, the credibility effect (emphasizing the decline or total elimination of default risk) and the expectational view of fiscal policy (focusing on initial conditions)—cannot, however, be claimed to be mutually exclusive. An unsustainable stance of fiscal policy (especially in its extreme form of an approaching fiscal crisis) will force the government to embark on fiscal tightening sooner or later. A crucial question concerning the emergence of non-Keynesian effects is whether the government's plan to reduce fiscal imbalances will come across as credible. The expectations of private agents will change only if the uncertainty in relation to the fiscal policy of the government can be eliminated and individuals do believe that the actions taken by the government will be ultimately successful and lasting.¹⁰ Credible and unexpected government actions, therefore, make it possible for individuals to expect a *less distortionary* taxation in the future, and in turn they will modify their expectations on permanent income in a positive direction and will start to increase consumption in the present, thereby compensating for the negative effect of reduced government consumption.¹¹ On the other hand, if the consolidation plan of the government comes through as unserious and doubtful, the policy action will not have an effect on the privates' intertemporal budget constraint and leaves the permanent income unchanged.

⁹ Amongst the main assumptions of the expectational view, the prevalence of distortionary taxation—as opposed to lump sum taxes—is crucial. In bad times the tax burden of individuals increases in a non-linear way. A credible consolidation, therefore, can prevent individuals to pay extra costs in the future.

¹⁰ Temporary actions leave individuals' expectations unchanged.

¹¹ Technically speaking, in case of a serious and credible macroeconomic stabilization attempt with the clear aim of reducing public liabilities, the intertemporal budget constraint of individuals will be tightened to a lesser degree, inducing privates to spend more in the present since they have to save less for the future.

3.2.1 Three explanations of non-Keynesian effects

Several theoretical publications have emerged immediately after the publication of the paper of Giavazzi and Pagano (1990), with the clear aim of providing a conceptual framework within which the non-Keynesian effects could be explained convincingly. The challenge was given by the surprising and well-documented outcomes of the Irish and Danish fiscal contractions which have been followed later on by others—as it has been demonstrated in Chapter 2. A theoretical rationalization of the “consumption puzzle”, i.e. the increased private consumption in times of improvement of the fiscal balance, was waiting to evolve.

Researchers’ aim has been ever since to explain the astonishing consequences of adjustments, to identify those *circumstances* and *initial conditions* which may prove to be indispensable in altering individuals’ expectations in a way to experience non-Keynesian effects. Nevertheless, beyond the fact that there are some cases of non-Keynesian effects, there is no consensus at all on how, through what channels and under exactly what conditions can these perverse effects be expected to evolve. In fact, the expectational view of fiscal policy is not a homogeneous research program. Some conceptualize the rational, forward-looking consumers’ behavior in a basically Keynesian setup with finitely lived consumers, assuming that government consumption is not a pure waste, etc. (this was the case in our former story where the switch occurred from a Keynesian to a Ricardian behavior). In some other instances, a neo/new classical model provides the basic setup with infinitely lived households without credit constraints and assuming that government consumption is a pure waste. Under this scenario, the switch means a change from a Ricardian to a Keynesian behavior. What remains the same in each theory is the assumption of the prevalence of distortionary taxation—as opposed to lump sum taxes. In passing, the three most well-known models on non-Keynesian effects will be discussed in some length: Blanchard (1990), Sutherland (1997) and Bertola and Drazen (1993).

3.2.1.1 Blanchard and his deterministic model

Blanchard (1990) was among the very first who tried to rationalize the empirical observation of non-Keynesian effects—in an article discussing the findings of Giavazzi and Pagano (1990)—by setting up a sim-

ple model. The author focused exclusively on the taxation side and raised the question whether a tax increase, given government spending, might generate expansion in consumption. He assumed that both taxation and debt have a critical value which automatically enforces the government to take actions. In a deterministic model, at any point in time, given the current tax and debt level (smaller than the critical values) and its dynamics, anyone can calculate the exact date of debt reaching the critical level, triggering a market-enforced adjustment.

Blanchard then argued that there are two channels by which government consolidation through taxes can affect expectations. First, the traditional one: an intertemporal redistribution of taxes from tomorrow to today which in turn reduces current generations' consumption. This effect is the stronger as long as consumers behave in a non-Ricardian manner. However, there is a second channel, too: "by taking measure today, the government eliminates the need for larger, maybe much more disruptive adjustments in the future and this may in turn increase consumption" (*ibid.* 111). That is, if consolidation takes place before the critical value of the debt level has been reached, the economy can be saved from a catastrophe which is good news to everyone (moreover, uncertainty decreases and precautionary savings can be lowered, too). The tax increase today, aiming at consolidating the fiscal stance, transforms expectations towards a less distortionary taxation tomorrow.¹² Nevertheless, the positive aggregate demand effect of tax rise can be expected only if both of the following two conditions are met: (1) the economy is getting close to an unsustainable stance and (2) the government is credibly committed to embarking on fiscal adjustment before the catastrophe burns out. Blanchard also emphasizes—albeit does not elaborate on it—that the proportion of Ricardian consumers (who do not follow any rule-of-thumb behavior in consumption decisions) must also reach an adequate level—a remark that will prove to be crucial in our analysis on non-Keynesian effects later on.

¹² In the model, marginal costs of taxation increase with the tax rate and the longer the government waits with the stabilization, the higher the tax increase has to be.

3.2.1.2 Sutherland's stochastic model

Sutherland (1997), similarly to Blanchard, puts the emphasis on the effects of distortionary taxation. However, he describes the evolution of debt as a stochastic process, that is, consumers never know exactly when stabilization will evolve in the future, although they naturally form expectations about it.

In *normal times* the probability of a fiscal adjustment (and therefore the burden in the form of higher taxes) is relatively low. Consequently, any government transfer to households may (and in fact can) exert a positive effect on aggregate consumption. Indeed, it is the traditional Keynesian effects that are at work. The fact that a Keynesian effect can be expected in an otherwise neoclassical model can be rationalized by the suspension of one of the crucial assumptions of the Barro-Ricardian equivalence, the infinitely lived (or intergenerationally altruistic) households. In Sutherland's stochastic model with finitely lived and selfish individuals the method of deficit financing does matter.¹³

However, the Keynesian effects in Sutherland's model disappear immediately as *bad times* (high and/or increasing debt) are assumed. In a fiscally unsustainable (or close to unsustainable) environment, households behave differently. In fact, they provide exactly the opposite reactions to government impulses as above. The finitely lived households will modify their assessments on permanent income and lower their current private consumption when the government implements a tax cut or raises government spending (further deteriorating the fiscal balance). The higher the debt-to-GDP ratio is (that is, the weaker the fiscal position of the country is), the higher probability will be attached to stabilization by individuals. With deteriorating fiscal conditions, individuals expect to experience stabilization in their own lifetime, since it is highly unlikely that the costs of adjustment can be shifted further ahead to the next generations. Importantly, due to dis-

¹³ As it has been shown with moderate level of debt, finitely lived individuals heavily discount future taxes because they face a positive probability of death and therefore there is a high chance that the tax rise will burden future generations only. However, Sutherland (1997) makes a remark by saying that the heavy discounting of the future tax burden is also possible due to an increasing population which means that the costs of the current increased consumption will be shared by a larger community.

tortionary taxation, the tax burden increases more than proportionally as the ratio of debt increases. In case of extreme values of debt, the expected costs of adjustment surpass the positive effects of any current government transfer paid to households; therefore, rational individuals react by keeping back the current consumption, following a behavior predicted by the neoclassical Barro-Ricardo equivalence.

The triggering factor in changing of the sign of the effects of government stimuli in the case of both Blanchard and Sutherland was the debt level—playing the role of initial condition. Both authors tried to show that the (permanent) increase in the level of debt induces individuals to reevaluate their current and future position via the intertemporal budget constraint and to enforce a switch from Keynesian to non-Keynesian effects.

3.2.1.3 A neoclassical formulation of non-Keynesian effects in the model of Bertola and Drazen

The former two models operated strongly with giving up one or more assumptions of the neoclassical model. Bertola and Drazen (1993), on the other hand, insisted on maintaining the usual setup of the neoclassical model. A distinguishing character of their model is that they focused on the expenditure side exclusively. Furthermore, while Blanchard (1990) and Sutherland (1997) focused on the changing level of debt as the trigger factor, Bertola and Drazen rationalized the emergence of non-Keynesian effects by concentrating on the level of government consumption.¹⁴

The novelty of their model comes when fiscal position turns into an unsustainable one. Rational, forward-looking households realize that the permanent increase in government consumption will result—at a certain point in time—in a non-sustainable position of public finances which triggers stabilization. In its simplistic form, rational individuals, knowing that adjustment must appear at some time in the near future,

¹⁴ Government spending follows a stochastic process with a positive drift in the model. According to the Brownian notion, after a while the growth of spending will reach an unsustainable level, where stabilization must occur. At this level, consumers will expect the government to cut back government consumption. However, consumers are uncertain about the exact level of spending which will trigger the stabilization.

revise their expectations and increase their consumption. The precise mechanism is the following: a further increase in government spending when the critical value is approaching has only a *decreasing* crowding out effect. In fact, in such a situation, the requirement of optimal consumption smoothing certainly implies a less than one-to-one crowding out. Perversely enough, in bad times a switch occurs in the effects of fiscal policy and the increase in government spending is followed by a relative increase in private consumption (with respect to the standard neoclassical case). The switch, however, means that a Keynesian phenomenon is being realized in a fundamentally neoclassical setting: a positive correlation between government and private consumption evolves.¹⁵ Consequently, an apparently irresponsible overspending in bad times triggers an expansion in economic activity exactly because the collapse and the inevitable stabilization is approaching.¹⁶

Concretely, their model differentiates between two states of the world: one where the level of government spending (g) may trigger a stabilization with a positive probability less than 1 (g^p) and another where stabilization occurs with probability 1 (g^s) and $g^p < g^s$. In both cases, individuals expect the government to initiate a regime change. First, by getting closer to g^p , households expect an adjustment in government consumption, therefore a (relative) increase in private consumption occurs since rational agents form their expectations about stabilization with a positive probability. Nevertheless, if the government fails to change the regime in the expected way (delaying adjustment), current consumption drops immediately at the point of g^p . The delay in adjustment and the sudden drop in private consumption reflects the fact that individuals realized at point g^p that the government is lacking the political commitment to initiate a fiscal consolidation.¹⁷

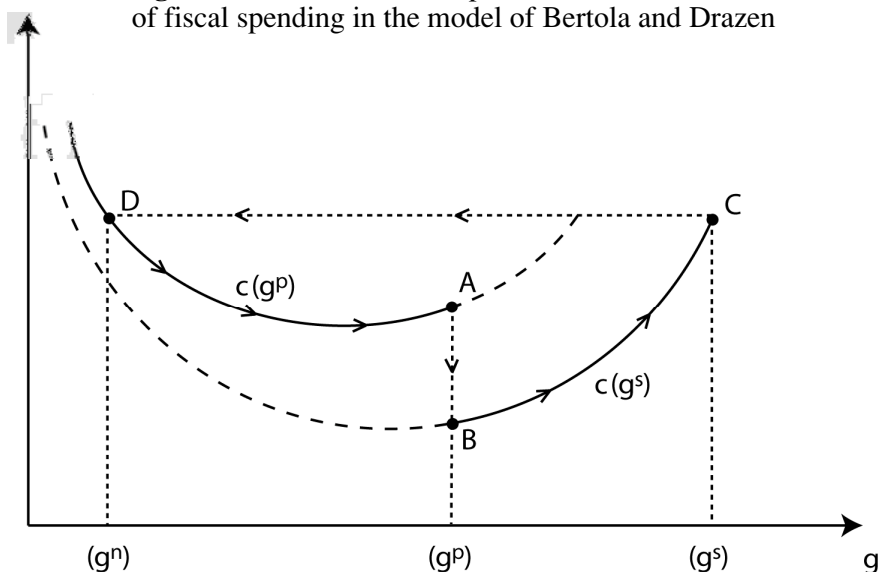
¹⁵ Based on some OECD countries' descriptive statistical analysis, the authors accordingly state that this is exactly what had happened in Ireland and Denmark and partly in some other OECD countries during the eighties.

¹⁶ In fact, even at relatively low levels of spending, the crowding out effect works at a less than one-to-one ratio because everyone knows that the spending is on an increasing path which means that sooner or later an adjustment should come.

¹⁷ It is worth emphasizing here that point g^p is not equivalent with the bad time situation (or crisis situation) where adjustment would occur for sure. The government has a choice at g^p , the question is whether the cabinet is ready to adopt a fiscal strategy of consolidation. At g^p , the government

Between g^p and g^s , private consumption starts to recover again as a response to increased government consumption because now individuals know for sure that stabilization occurs next time with probability 1. At g^s , when the regime-change has been finally realized, current consumption does not change at all because the adjustment in households expectation has taken place earlier—in fact, at g^s the occurrence of stabilization is known for sure. At this point then, the level of private consumption equals with the consumption level of normal times. See the mechanism in Figure 3.4.

Figure 3.4 The schematic representation of the effects of fiscal spending in the model of Bertola and Drazen



Source: adapted from Bertola and Drazen (1993:19), following the simplifications of Siwinska and Bujak (2003:11), complemented by my own modifications.

Remarks: A: discretionary action for regime change with positive probability but less than one (triggered by g^p); B: regime change has not occurred, lowered private consumption; C: regime change with probability 1 (triggered by g^s); D: return point (normal times with government consumption of g^n). The function $c(g^p)$ shows consumption behavior of privates for $g^p < g^s$; while $c(g^s)$ is consumption behavior for g^s . Bold line (with arrow) shows transition of consumption over time; dashed lines with arrow refer to one-time change.

sends a signal to privates to which market agents react accordingly. That is, while the situation at point g^s can be described as a crisis scenario adjustment, at g^p another kind of consolidation may evolve, called the commitment or signalling scenario adjustment. Such a distinction was initiated by Carlin and Soskice (2005), for instance.

3.2.2 Testing for non-linearity in demand

Technically, the empirical estimation of non-Keynesian effects means that by testing a consumption or a saving reaction function, authors try to explain the switch in the *sign* of the response of private consumers due to a changed profile of fiscal policy. The function comprises both differences and lagged values of variables, often called the distributed lag model, a convenient and simple form of econometric modelling. An appealing feature of the specification is that it makes the researcher able to nest both the conventional Keynesian view of consumption, and its neoclassical approach. The estimation technique comprises of the usual OLS estimation and the two-stage least squares estimation method (instruments are generally the lagged values of the variables). Höppner and Wesche (2000:5) expresses the advantage of such a model succinctly: “This specification ... has proved [to be] sufficiently flexible to capture the time-series aspects of the data as well as the main determinants from the theory.”

From a purely empirical point of view, the crucial question is the following: what triggers the change in behavior? The answers form two categories: the initial conditions; and the size of adjustment. As far as the first triggering factor is concerned, the concept of non-linearity makes it overt that according to the expectational view, initial conditions can have a strong determining role in the occurrence of expansionary effects of fiscal consolidation. The worse is the economic situation, i.e. the closer is the economy to unsustainability or even crisis, the higher will the chance be for the government to undertake the crucial consolidation efforts. In the presence of a high debt-to-GDP ratio for instance, the government may increase public spending without the expected textbook results, since individuals expect their tax burden to increase significantly in the near future. Therefore, no increase occurs in private consumption; or to put it differently: the standard Keynesian effects will not evolve anymore.

Perotti (1999) proposed that the switch in expectations occurs only in times of high and increasing debt ratios. During the so-called “bad times”, the distortionary effects of taxes will be so much higher that any additional public spending will trigger individuals to consume less, due to the *wealth effect*. (To apply the concepts of this chapter introduced earlier, the consumers will become Ricardians in bad times, while they follow the Keynesian rule-of-thumb behavior at normal times.)

Bhattacharya (1999) proved to be highly supportive to this statement having analyzed the relationship between debt and non-linear effects both on a country-by-country basis and with a panel approach. According to his results, above a critical level of the debt-to-GDP ratio (at somewhere around 30–40 per cent), the textbook Keynesian reactions of households to fiscal policy measures deteriorates significantly, that is, the more indebted a country is, the less effective a fiscal stimulus will be. On a much smaller sample (including regional data on Italy and Canada for forty years), Pozzi (2001) found support for this view, too. Although in a different framework, McDermott and Westcott (1996), using an OECD panel, claimed that the initially high level of debt can significantly contribute to the effectiveness of the *credibility channel*.

Turning now to the second triggering factor, the size of adjustment, Giavazzi and Pagano (1990 and 1995) argued that the switch of expectation was conditioned on the initiation of a *large* adjustment, which proved to be persistent (i.e. the debt-to-GDP ratio was lowered significantly). The authors explained the boost in private consumption, which could turn the fiscal multiplier into negative, by the wealth effect. Giavazzi, Pagano and Jappelli (2000), repeated the analysis with a larger sample of OECD countries and confirmed their previous results: fiscal impulses must be adequately large and persistent to give rise to expansionary effects in times of fiscal consolidation. They supplemented their earlier findings and claimed that non-Keynesian effects are expected to occur with a higher probability if the government modifies taxes and transfers paid to households as opposed to changes in public consumption. Moreover, the authors added that the level and dynamism of debt was not a good predictor at all. Afonso (2001) also affirmed the importance of the taxation side on a sample of EU countries; by emphasizing the significance of the *consumption channel*. He also claimed that fiscal policy has an asymmetric character in the sense that while consolidations may have a perverse effect, fiscal profligacy does not provide evidence for non-Keynesian effects.

As far as the sceptics are concerned, Van Aarle and Garretsen (2003) repeated Giavazzi and Pagano's (1995) analysis by applying different definitions for the term "exceptional". The authors were not able to prove the importance of regime changes, thereby denouncing the relevance of the expectational view in explaining non-Keynesian effects.¹⁸

¹⁸ By regime change, the change in government's saving position is meant.

The importance of their findings lies in the fact that they documented how sensitive results can be to the applied definitions and concepts—a point also supported by Horváth et al. (2006). Miller and Russek (2003) found only a limited evidence for the relevance of trigger points such as the size of adjustment or initial conditions. Schlarek (2004) rejected harshly the expectational view by claiming that government spending shocks have Keynesian effects exclusively—no regime change can be expected to occur therefore. He also found that tax shocks have no effect whatsoever on private consumption. The peculiarity of his study is that the test was conducted not just for developed but also for developing nations. Applying a more restricted focus, Prammer (2004) defeated the conviction that Austria faced an expansionary fiscal consolidation in the years between 1995 and 1997, a view strongly advocated by Giudice et al. (2003). Hogan (2004), on the other hand, did find some limited evidence in favor of expansionary effects. However, he emphasized that the induced increase in private consumption in times of financial crises cannot sufficiently offset the negative effects of fiscal contraction, that is, “fiscal contractions are not literally expansionary” (ibid. 649).

Besides the *ex post* data analysis of exceptional fiscal episodes (with the fundamental aim of identifying the defining characteristics and consequences of fiscal consolidation), the other often used approach in empirical literature is the conduct of *ex ante* macroeconomic simulations. Reviewing the literature, Briotti (2005) arrived at the conclusion that macroeconomic model simulations provided no convincing results for negative fiscal multipliers. In fact, multipliers turned out to be positive in the short run, although the size of the multiplier declined over time. Models also confirmed the general claim that tax changes had a smaller multiplier effect than changes in spending. Nevertheless, although simulations in general are not too promising in the case of short-term expansionary effects, there is a higher probability of having a negative multiplier in the medium and long run—see especially the study of Giudice et al. (2003), who used the European Commission’s QUEST model and tested the relevance of both the consumption and investment channels. They confirmed the prevalence of non-Keynesian effects in the medium term, but also supported the claim that a decline in risk premia—especially in case of a highly indebted country—can boost economic activity even in the short term through the credibility effect.

3.2.3 Descriptive analysis of the EU-14

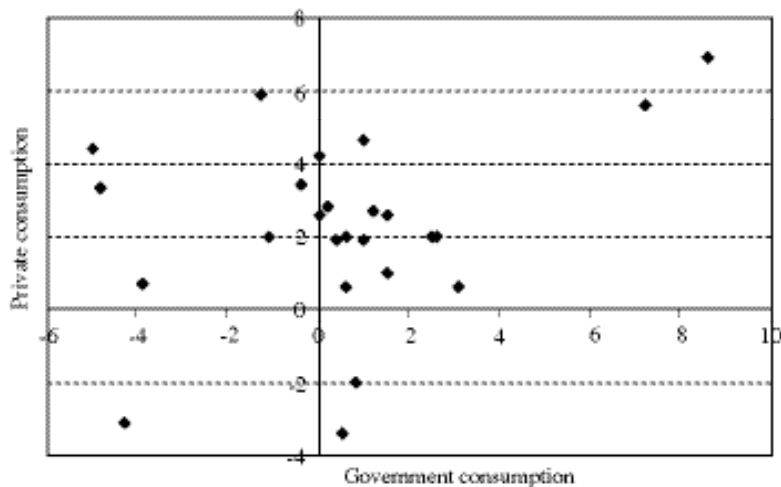
Our EU-14 sample provides an easy ground to test what type of relationship can be detected between individuals' behavior (or more precisely: private consumption) on the one hand and fiscal consolidation on the other hand. The 25 non-Keynesian occasions of Chapter 2 make it possible to draw some inferences regarding the sign of the association of the variables. Generally speaking, fiscal consolidation is pursued either by reducing budget spending or increasing taxes. Therefore, in this section changes in both government consumption and direct taxes will be contrasted with the change in private consumption. Second, relying on the findings of the empirical literature on non-Keynesian effects, the debt-to-GDP ratio and its acceleration will be reflected upon.

According to the Keynesian rule-of-thumb behavior, private consumption and government consumption should have a positive correlation, while non-Keynesian effects by definition assume an inverse relationship between the two.¹⁹ In the case of direct taxes the sign of correlation is just the opposite. The results are summarized in Figure 3.5a and 3.5b (see the entire data set in Appendix 4).

The figures allow us to draw interesting conclusions. First of all, in the year of the observed expansionary effects, only 3 out of the total 25 episodes resulted in a drop of private consumption, all the other cases show an increase. Moreover, almost half of the expansionary episodes resulted in a more than 2 per cent positive change in private consumption. Our first impression can be therefore that non-Keynesian effects might be explained by the rise in private consumption, which could partly or fully offset the first round decline in aggregate demand. The question is whether the increase in private consumption was triggered by (or at least coincided with) the decline of government consumption and/or the increase in taxes.

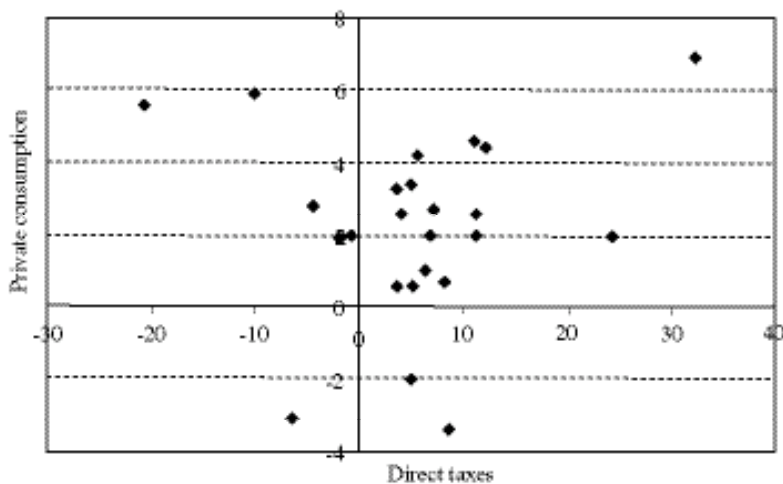
¹⁹ If the expectational view of fiscal policy is correct, then in the case of non-Keynesian effects consumers either follow a Keynesian behavior before the adjustment and will shift to a Ricardian one at the time of the regime change, or consumers will behave in normal times as predicted by neoclassical models and will adopt a Keynesian consumption function in the year of adjustment.

Figure 3.5a Relationship between the change of government and private consumption



Source: own calculations based on European Commission (2005).

Figure 3.5b Relationship between the change of direct taxes and private consumption

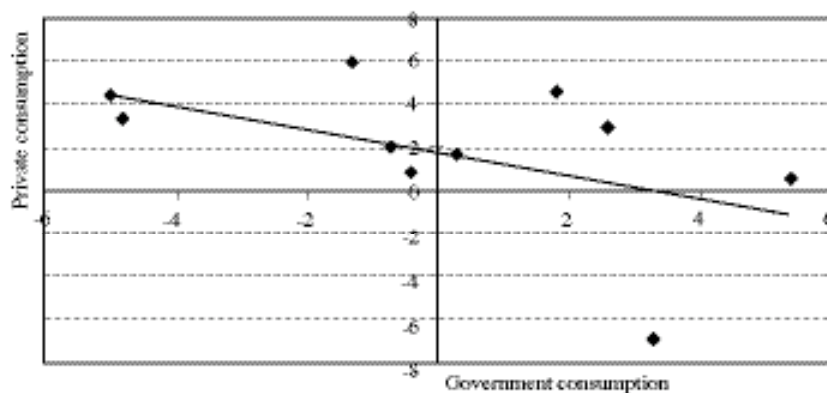


Source: own calculations based on European Commission (2005).

The sample shows that a drop in government consumption at the year of adjustment did indeed coincide with a rise in private consumption on some occasions. The episodes of the upper left quarter of Figure 3.5a

seem to reflect that consumers adopted a Ricardian behavior in times of fiscal consolidation. This was the case in Austria (1997), Denmark (1983 and 84), Greece (1994) and Ireland (1987–89). The relationship seemed to be extremely strong in the textbook episode of Ireland: government consumption was decreased in three subsequent years by 4.8, 5.0 and 1.3 percentage points annually, and private consumption was able to react with a subsequent increase (by 3.3, 4.4 and 5.9, respectively). The inverse relationship can be detected in the early eighties, too, with a different sign, however: increased government consumption was followed by a decrease in private consumption in Ireland. It seems as if Irish people followed a *Ricardian* behavior throughout the whole decade in the eighties, depicted by Figure 3.6a, which then shifted to a *Keynesian* behavior in the last fifteen years, following the extensive consolidation efforts carried out previously (see Figure 3.6b). In all the other cases of expansionary fiscal consolidations in our EU-14 sample, however, the numbers mirror a Keynesian consumption function with a positive relationship between government and private consumption (the upper right and the lower left quarters of Figure 3.5a). Moreover, the bulk of expansionary episodes (17 out of total 25) witnessed an increase of government consumption at the time of fiscal adjustment, strengthening the suspicion that governments are rather unwilling to cut back public spending at times of fiscal contraction.

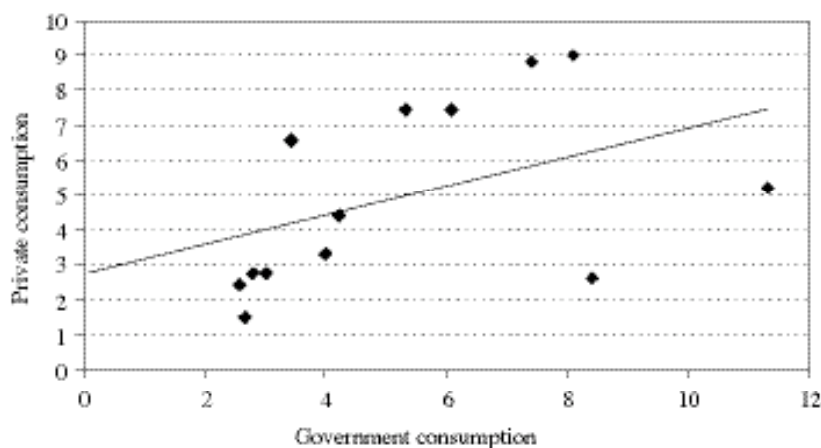
Figure 3.6a An inverse relationship between the change of private and government consumption in Ireland in the eighties



Source: own calculations based on European Commission (2005).

Remarks: the slope of the curve is -0.53 and the value of fit is 0.24.

Figure 3.6b A positive correlation between the change of private and government consumption in Ireland in the nineties and after 2000



Source: own calculations based on European Commission (2005).

Remarks: the slope of the curve is +0.42 and the value of fit is 0.26.

Turning now to the taxation side (Figure 3.5b), the picture is more promising, however. Almost in every case a rise in direct taxation coincided with an increase in private consumption (the upper right quarter of the figure), as presumed in Blanchard (1990). By taking a look at the data set of Appendix 4, we can also see that the British (1997–98), the Greek (1994), the Dutch (1993 and 1996), the Portuguese (1988) and the Swedish (1987) attempts proved to be outstandingly successful. It seems that even the Danish (1983–84) can account their high citation in the literature to the tax increase.²⁰ The Netherlands in 1993 provides an interesting case. While the relation of private and government consumption suggests the existence of the usual Keynesian function, the taxation side seems to defy it.

Next, the role of the debt-to-GDP ratio is analyzed. Unfortunately, the results regarding the role of the debt-to-GDP ratio and/or the rate of acceleration of debt are also inconclusive in our sample of the EU-14. Figures 3.7a and 3.7b reveal the evolution of debt-to-GDP ratios before and after the occurrence of non-Keynesian effects. The Irish

²⁰ Chapter 4 (sections 4.2.2 and 4.2.3) will turn exclusively to the question of whether spending cuts or tax increases can contribute to the realisation of expansionary effects.

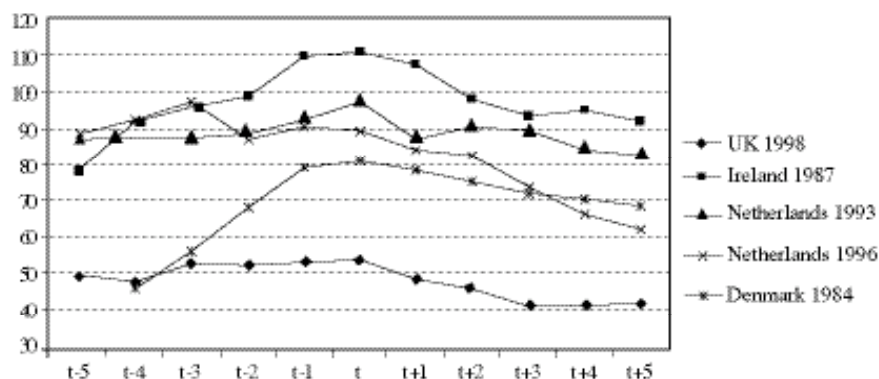
(1987–89), the Danish (1983–84), the Dutch (1993 and 1996) and the British (1997–98) cases are the most self-evident ones. The acceleration of debt ratios preceding the consolidation was followed by an immediate and significant drop at the time of fiscal consolidation and proved to be persistent.²¹ In Sweden (1983), Portugal (1986) and Austria (1996), fiscal consolidation was preceded by a significant acceleration of debt-to-GDP ratios, which stopped the further rise of debt, but did not induce a drop afterwards. Sweden embarked upon another adjustment three years later which proved to be expansionary, too, and that attempt had already resulted in a falling debt ratio (although at $t+4$ the ratio started to climb again).²²

As far as the rest of non-Keynesian effects are concerned, no such convincing trend can be detected. Although the debt-to-GDP ratio increased substantially in each case before the adjustment (see Figure 3.7b), there was no break in the trend afterwards, instead, the ratio continued to increase. To use the term we have introduced in Chapter 2, these fiscal adjustments can be labeled as unsuccessful ones. The strangest performance was provided by Italy. According to our statistical analysis of Chapter 2, the country experienced expansionary effects in 1983 (with a debt-to-GDP ratio of 71.3 per cent) for the first time in the eighties. The steady rise of the debt ratio, however, did not stop, instead it accelerated and went above 100 per cent by 1990. The next expansionary fiscal consolidation was documented in 1993 (with a 120.2 per cent debt ratio). However, it still did not prove to be the upper limit for the Italian indebtedness. Accordingly, there might not have been a causal relationship between the acceleration of economic growth and fiscal adjustment in Italy. Other factors should have been responsible for triggering the increased economic growth (see especially the Italian case study of Alesina and Perotti 1996a).

²¹ Further elaboration on each of these fiscal episodes can be found in section 4.2.3.

²² Portugal also embarked on another expansionary fiscal adjustment in 1988 which, however, did not turn down the trend of the debt ratio either.

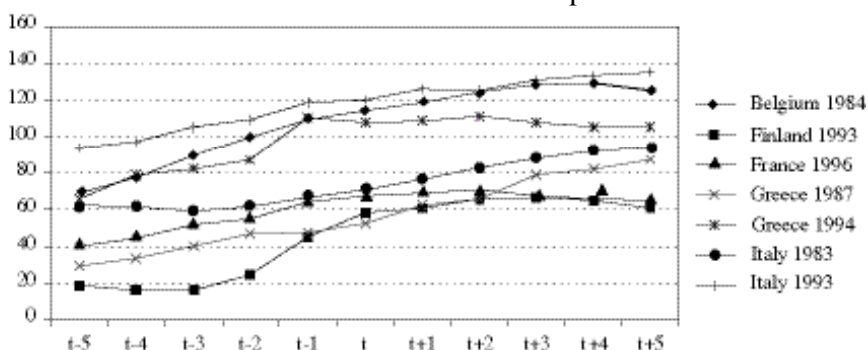
Figure 3.7a The evolution of debt-to-GDP ratios:
Some successful attempts



Source: own calculations based on OECD (2005a).

Remarks: data are per cent of the GDP. Fiscal adjustment was initiated at time “t”.

Figure 3.7b The evolution of debt-to-GDP ratios:
Some unsuccessful attempts



Source: own calculations based on OECD (2005a).

Remarks: data are per cent of the GDP. Fiscal adjustment was initiated at time “t”.

Figures 3.7a and 3.7b also reveal that debt ratios vary substantially — between 53 per cent (in the UK) and 120 per cent (Italy), that is, the *level* of the debt ratio itself may not be a good predictor of the shift in the behavior of rational agents. The numbers (levels) have to be always interpreted within the context of a given country. While the relatively low level of 53 per cent in the UK (1997–98) or Greece (in 1987) proved to be enough to trigger a fiscal adjustment which in turn resulted in an

accelerated economic growth in the same year, much higher levels, well above 100 per cent, did not trigger the same change in agents' behavior.²³ It is more likely therefore that it was the *acceleration* of the debt ratio that provided the required impetus for the people to change their behavior.

In sum, the expectational view and the concept of non-linearity of demand may provide an interesting and appealing explanation for non-Keynesian effects—at least from a theoretical point of view. Their attempt to combine the Keynesian and Ricardian behavior does deserve special attention. Nevertheless, reviewing the empirical literature and conducting a simple but straightforward statistical analysis on a sample of the EU-14, the empirical justification of the theoretical approach has remained yet indebted with a clear-cut support of the theory. The results are simply inconclusive. Although several authors of the demand-side literature claimed that non-Keynesian effects are more than just theoretical constructs, the robustness of empirical findings is still weak. In fact, no study has been able to come out yet with undisputable empirical support. The expectational view of fiscal policy is indeed *not* the whole story for explaining the acceleration of economic growth at times of fiscal contraction.

3.3 Intertemporal decisions—the modern theory of consumption

While the expectational view of fiscal policy may still lack irrefutable empirical support, it has proved to be strong in theory and attracted an increased interest in the academia. However, the expectational view, assuming a shift in consumers' behavior, builds its theoretical setup on several conditions which may or may not be met in reality. Next therefore, a deconstruction of the expectational view will follow, by exploring that one of the assumptions, the lack of liquidity constraint, can strongly invalidate the practical usage of the theory. If so, it may lose its significance in providing policy recommendations to accommodate the occurrence of non-Keynesian effects. But on the other hand, it also reveals how important financial deregulation and the deepening of financial intermediation can be in the weakening of the credit constraint and in increasing the chance for people to act as predicted by the models of expectational view.

²³ See among others Belgium, Italy or Greece in the nineties.

As we argued above, expectational view bases its conceptualization of non-Keynesian effects on the combination of the rational expectations theory and the permanent income hypothesis. Its main claim is that rational, forward-looking consumers are able to react to policy changes via the modification of their expectations of their prospective wealth status. If our main goal is to gain a better understanding of the working of perverse fiscal effects and more importantly to gather together those conditions that are inevitable to experience non-Keynesian effects, it seems to be a good starting point to discuss in some length the development of the consumption theory, focusing mostly on the life-cycle and permanent income hypothesis and the rational expectations breakthrough in modelling consumption behavior. By introducing Robert Hall's famous stochastic permanent income model, it becomes possible to establish a ground for linking together modern consumption theory and non-Keynesian effects. Moreover, the criticism of the model possibly helps us (1) to uncover some of the shortcomings of the non-Keynesian theory; and (2) to understand why it is rather difficult to find empirical support of the occurrence of non-linear effects of fiscal policy.

The intertemporal choice model of Irving Fischer can be interpreted as a criticism towards the Keynesian consumption function which determines current consumption as a simple function of current disposable income or some other lags of it. Fischer (1930) instead explained current consumption by current and future income, that is, he adopted a forward-looking calculus of consumption behavior. By introducing the concept of the *intertemporal budget constraint* of individuals, he was able to establish a link between consumption and the expected total (lifetime) resources, or in other words, wealth. It is not an exaggeration to say that by arguing that consumption decision was based on lifetime earnings, Fischer established modern consumption theory.

It was Fischer's new approach to consumption behavior that induced Modigliani and later on Friedman to develop their own concepts to address some of the puzzles which remained unexplained by Keynesian consumption functions, such as the difference between long-term and short-term consumption functions. Modigliani's life-cycle hypothesis helped enormously to understand why people are inclined to smooth their consumption over time, a phenomenon that contradicts traditional arguments. Modigliani's main interest was to show how people are able to guarantee a relatively stable (or constant)

standard of living even in the presence of fluctuations in income throughout their lives by operating with saving and dissaving.²⁴

While Modigliani assumed, however, that income follows some regularity, that is, wealth increases definitely throughout the working years, while it decreases after that; Friedman adopted a rather different approach by assuming that income is a production of an uncertain, random process, where transitory changes may occur. Friedman (1957) disaggregated income into two main elements: permanent and transitory. A change in *permanent income* has a (close to) one-to-one effect on private consumption, while a change in the transitory part may have only a rather small impact, since it should be spread over the whole lifespan (that is, marginal propensity to consumption must be different in the two cases, being close to zero in the latter case). The permanent income hypothesis states accordingly that there exists a steady rate of consumption throughout the lifetime of an individual—taking into account his current wealth status and the future flow of income. Nevertheless, Friedman's radical change came with the statement that private consumption is not simply a deterministic function of future (permanent) income but it is the expectations of agents about their future wealth that determines consumption. Expectations therefore became a strong building block in the understanding of consumption behavior.

The further development and formalization of Modigliani's and especially Friedman's theory came with the appearance of new classical macroeconomics which combined the life-cycle/permanent income hypothesis (LC-PIH) with the concept of rational expectations. Hall (1978) showed that if forward-looking consumers held rational expectations and the permanent income hypothesis was valid, private consumption would follow a *random walk*, which means that the change in consumption cannot be predicted by testing for lags in income or any other variables. Only unexpected or surprise changes in the expected lifetime income can have an effect on consumption (due to technological change or policy change, etc.). The best guess for any future value of consumption is its current value.²⁵ (See the formalized version of Hall's stochastic permanent income hypothesis in Box 1.)

²⁴ See especially Modigliani and Brumberg (1954), and Modigliani (1986).

²⁵ Carroll (2001:24) warns, however, that Friedman's consumption theory, which was based largely on intuition, cannot be considered straightforwardly as the basis for Hall's model since the former has more resemblance to reality—see especially the role of precautionary savings.

Box 1 Hall's stochastic permanent income hypothesis

Assuming quadratic utility function and non-stochastic asset return (i.e. $r_{t+i} = \rho$ for all i), Hall showed that

$$c_{t+1} = c_t + \varepsilon_{t+1},$$

where ε_{t+1} is white noise with $E(\varepsilon_{t+1}) = 0$ and $V(\varepsilon_{t+1}) = \sigma^2$, and does not correlate with anything.

The random walk result comes from the stochastic Euler equation (the first order conditions necessary for an optimum):

$$\begin{aligned} MU(c_t) &= [1 / (1 + \rho)] * E_t [MU(c_{t+1}) * (1 + r_{t+1})] \\ &= 1 / (1 + \rho) * \{E_t [MU(c_{t+1})] * E_t (1 + r_{t+1}) + \\ &\quad \text{Cov} [MU(c_{t+1}), r_{t+1}]\} \end{aligned}$$

where it has been assumed that representative consumer maximizes:

$$E_t \sum_{s=0}^{\infty} [1 / (1 + \rho)^s] U(c_{t+s})$$

and $U' > 0$ and $U'' < 0$.

Applying the assumptions, the stochastic Euler equation simplifies to:

$$MU(c_t) = E_t [MU(c_{t+1})]$$

which in turn expressed in level terms gives:

$$c_t = E_t (c_{t+1})$$

providing Hall's stochastic version of the permanent income hypothesis, where consumption is a martingale.

3.4 Non-Keynesian effects and the criticism of Hall's stochastic model—the importance of liquidity constraints

The theoretical findings and the empirical implications of the stochastic model of the permanent income hypothesis were radical and extreme: no lagged values of consumption and income can be used in future forecasts and more importantly only changes in expectations on future income can explain current consumption. Besides the straightforward implications, another value added of Hall's approach was the revival of the empirical testing of consumption behavior. Reality, however, has contradicted the pure theory of consumption behavior based on the random walk assumption. According to empirical research, in certain

cases consumers do base their consumption-decisions on the lagged values of disposable income or simply disregard the news related to the future prospects of income and wealth. The concept of “excess sensitivity” refers to a situation where Hall’s consumption model seems to fail: consumption reacts too strongly to predictable (anticipated) changes in income. The over-reaction in this case is not due to the innovation term itself, but to the expected and known element of income. That is, the assumption of rational and forward-looking consumers does not necessarily imply that private consumption should follow a random walk. If changes in consumption can be related to predictable changes in income, however, then the government should also be able to manipulate macroeconomic aggregates. Mankiw concludes accordingly that “[a]lthough [the] literature does not speak with a single voice, the consensus view is that consumption smoothing is far from perfect. In particular, consumer spending tracks current income far more than it should” (Mankiw 2000b:120).

If, however, rational and forward-looking consumers cannot smooth out their consumption over their lifetime, the chance for realizing non-Keynesian effects may also be dramatically undermined. Demand-side approaches of non-Keynesian effects assume that it is a change in the permanent income of individuals that can trigger a rise in private consumption and thereby overall aggregate demand in case of a fiscal contraction. Accordingly, the higher the share of the population who fail to smooth consumption and therefore determine its consumption by considering current income only, the less ideal is the situation for experiencing expansionary effects. A logical question arises therefore: what induces individuals to adopt a rule-of-thumb behavior—a situation when consumers spend a fixed portion of their income on current consumption. In order to understand why reality contradicts Hall’s stochastic PIH theory, we need to turn to the underlying assumptions of the model.

Fortunately, Muellbauer (1994) offers an exhaustive list of the underlying assumptions, the defeat of which would provide great many opportunities to depart from the predictions of Hall’s model. These are:

- (i) no credit constraints or other non-linearities in the budget constraint;
- (ii) quadratic utility function additive over time;
- (iii) no habits or adjustment costs;
- (iv) only non-durable goods are consumed;

- (v) consumers are homogenous, the subjective discount rate (ρ) of individuals is the same (constant) for everyone and equals to the real interest rate (non-stochastic, i.e. constant market real interest rate);
- (vi) no measurement error or transitory shocks to consumption;
- (vii) the coincidence of the frequency of consumers' decision making with the frequency of the data;
- (viii) rational expectations.

According to the first assumption of the stochastic PIH model, rational, forward-looking households can borrow *without* limits in order to achieve consumption-smoothing over time. However, in real-world economy, this is hardly true. What we find instead is a dramatic variance in the degree of accessibility to credit markets, across countries and over time. As a matter of fact, while people are indeed alike in the sense that they behave rationally, they do face *different constraints*. In a simple model of Campbell and Mankiw (1989) for instance, the “ λ ” fraction of the population followed a rule-of-thumb in their consumption decisions, behaving as if they were Keynesians in both normal and bad times, in strong contrast to Hall's model. The general explanation for the existence of such a non-optimizing portion of the population is the failure of assumption 1. See Box 2.²⁶

In the presence of liquidity constraint, individuals will base their consumption decisions on current income alone, irrespective of the possibility of the increase in future permanent income.²⁷ Accordingly,

²⁶ Certainly, myopia, a missing factor on the list, might also be responsible for the excessive sensitivity of individuals. However, it is rather general tendency of economic models to work with the assumption of perfect foresight. Moreover, several empirical studies—including Flavin (1985), Jappelli (1990) and Chah et al. (1995)—came to the conclusion that borrowing constraints have a much stronger effect on individuals' consumption decisions than myopia. This result can prove to be crucial since it also implies that albeit the predictions of Hall's stochastic permanent income hypothesis may not be valid, agents are nevertheless still rational in their decision-making and behave in a more or less forward-looking manner.

²⁷ Those who cannot borrow and their consumption is determined entirely by current income have a much higher marginal propensity to consumption (MPC) in response to temporary changes in income (in contrast with PIH). For constrained individuals the MPC out of the transitory income is indeed close to one (while in the case of PIH it should be close to zero).

Box 2 An empirical test of the stochastic PIH

Campbell and Mankiw (1989) in their empirical testing of consumption behavior for instance constructed a model which combines Hall's random walk consumption theory and the traditional consumption function by assuming a world populated with heterogeneous households. In the stochastic PIH model, the change in consumption equals the innovation term (ε_{t+1}), while in the traditional model the change in consumption can be traced back to proportional changes in the disposable income as a rule-of-thumb. Assuming that a certain part of the population (λ) follows the traditional consumption function (Keynesian consumers have adopted a non-optimizing behavior) and the remaining part ($1-\lambda$) behaves as it has been predicted by Hall's model (labeled sometimes the Ricardian consumers), the aggregate change in consumption equals:

$$\begin{aligned}\Delta C &= \lambda \Delta C_{\text{TRAD}} + (1-\lambda) \Delta C_{\text{PIH}} \\ &= \lambda \text{MPC} \Delta Y^d + (1-\lambda) \varepsilon_{t+1}\end{aligned}$$

If Hall's random walk model is correct, ΔC should equal the innovation term, where $E_t(\varepsilon_{t+1}) = 0$, and λ has to be zero, that is,

$$H_0 : \lambda = 0 \text{ and } H_1 : \lambda > 0.$$

However, the authors were not able to support H_0 since they found a statistically significant value for the part of the Keynesian population: half of the consumption behavior was explained by current income.²⁸

²⁸ One of the most serious criticism against the method of Campbell and Mankiw is the small number of observations and the consequently questionable robustness of the test. Shea (1995), however, based his test on micro data (a panel of unionized labor) and confirmed the prevalence of a strong positive relation between predictable income changes and changes in consumption. The importance of his approach is easy to follow: wage contracts make future changes in income highly predictable. According to the permanent income hypothesis, such an expected change in the future cannot have any real effect (since these are taken into account at the moment the agreement is signed). Shea, however, found just the opposite: 1 per cent raise in the wage was followed by 0.89 per cent increase in consumption. Other empirical tests of the permanent income hypothesis provided additional evidence that Hall's model is not able to account for the behavior of every single individual—see especially the early works of Flavin (1985) and Hayashi (1985).

Mankiw (2000b:460) states that with the liquidity constraint “Keynes’s original consumption function starts to look more attractive”.²⁹ However, what might be appealing from a purely academic viewpoint such as Gregory Mankiw’s, it can be devastating for those who advocate the emergence of non-Keynesian effects on the basis of lacking liquidity constraint. Liquidity constraint certainly means that individuals are *not able* to or are *not allowed* to borrow as much as they want.

Elaborating on non-Keynesian effects—in accordance with the empirical findings of Campbell and Mankiw (1989)—Perotti (1999) divided private consumers into a credit-constrained and a non-constrained group. With a mixed consumption function, Keynesian consumers spend all their current disposable income, while unconstrained individuals can assess the net wealth effect of a tax cut by confronting the expected positive effect of output stimulus and the expected negative effect of higher future tax distortions.³⁰ In accordance with the assumptions of the model, the findings of Perotti (1999:1400) are quite close to those of Blanchard (1990) or Sutherland (1997), analyzed in section 3.2.1; that is, under the assumption of a heterogeneous society “government expenditure shocks have a positive, ‘Keynesian’ correlation with private consumption in normal times, and a negative, ‘non-Keynesian’ correlation in bad times.”

Similarly to Blanchard (1990), Perotti argues that an unexpected tax increase may stimulate the private consumption of unconstrained consumers (and only those), since higher taxes today may prevent a drastic tax increase with much higher distortions to emerge later on. As far as the spending side is concerned, while Keynesian consumers always react to the increase of public expenditure in the predicted traditional way, the reaction of rational and unconstrained consumers will depend on the relative strength of the stimulus, as compared to increased

²⁹ And he continues by saying that “current income appears to have a larger role in determining consumer spending than the random walk theory suggests” (ibid. 460).

³⁰ Perotti (1999), in his attempt to rationalize the occurrence of non-linear effects of fiscal policy, departs from the underlying assumptions of the neoclassical model significantly. He assumes, among others, that government consumption is not a pure waste, since nominal and real rigidities exist. Similarly to Blanchard (1990) and Sutherland (1997), he assumes finite lives (albeit policymakers have a higher discount rate than private agents), and also tax distortions increase disproportionately with the size of tax.

future tax liabilities. If the economic activity increases more than the distortions themselves—implying a positive net effect of increased public spending—unconstrained individuals will consume more, too (just like the Keynesian ones, although the extent of the reactions of the two groups may be substantially different). However, if tax distortions outweigh the positive effect of fiscal stimulus on aggregate demand, the reaction of unconstrained consumers will follow the neo-classical pattern, that is, a decline in private consumption, implying a negative multiplier. Accordingly, in normal times there is no difference between the reactions of the two groups. However, in bad times, the aggregate effect of the private responses depends entirely on the share of unconstrained to constrained consumers. The condition for expansionary fiscal consolidation is therefore that the share of unconstrained individuals must be adequately high.

Necessarily, the following (interrelated) question(s) arise(s): why does liquidity constraint exist, how can it be measured and how can it be overcome? Regarding the first question, according to many, one of the main reasons for the prevalence of liquidity constraint is the underdevelopment of financial markets and/or the imperfect working of credit markets—see especially the seminal work of Jappelli and Pagano (1989), and Fissel and Jappelli (1990). In the LC-PIH models “[c]apital markets are assumed to be perfect so that agents may lend and borrow at will, and so are never constrained from their optimal consumption plans in any period. However, if capital markets are not perfect, consumers may be prohibited from satisfying their ‘desired’ consumption plans, and are, as a result, liquidity constrained” (Fissel and Jappelli 1990:253).³¹

Putting together all of these pieces of the puzzle, it is reasonable to claim that *the prevailing huge variance in the degree of financial depth*, especially the degree of accessibility to credit markets, *can be a determining factor for the emergence of non-Keynesian effects*. The different degrees of the development of financial (intermediation) systems may partly explain why specific countries experience the expansionary effects while others only to a lesser extent or not at all.

³¹ Certainly, liquidity constrained consumers who are not able to gain a direct access to credit markets may find it appealing to borrow from friends or relatives who are wealthy enough or who are not constrained. This point, however, is not elaborated in the text. See Cox and Jappelli (1990) for more detail on this point.

3.4.1 Measuring liquidity constraint in developed economies

Before turning to the assessment of some empirical findings in the literature, it is worth raising once again the question of why liquidity constraints, or more precisely the number of consumers suffering from credit denial, could be important from a *policy* point of view. Liquidity constraints, indeed, can have serious implications for policy decisions, especially regarding the issue of targeting. The ultimate effect of any fiscal decision is largely sensitive to what portion of the population suffers from credit constraint. In the presence of liquidity constrained individuals, a tax cut for instance would not be followed by more consumer savings in order to finance the future burden of tax increase, as it is predicted by the neoclassical Barro-Ricardian equivalence. Instead, the cut would increase aggregate demand—an implication that contradicts with PIH. Accordingly, the existence of credit constrained individuals undermines policy-neutrality: even temporary changes in fiscal spending/revenues can have a positive multiplier effect. Importantly, these cuts would work more effectively if government policies were able to target those individuals who are relatively young, earn relatively less and do not have an established credit history, do not possess houses or other assets, that is, the low-savers. Large families are usually also among the targeted groups since they are expected to be more credit-constrained.

Barro (1974) demonstrated that even if the neoclassical assumption of infinitely-lived households holds, any switch from tax-financed government spending to debt accumulation may alter consumer behavior significantly—due to the presence of the liquidity constraint. The neutrality postulate of neoclassical economics in such an environment will fail to exist. Not just permanent changes in the tax path, but also temporary ones may alter individuals' decisions concerning current consumption. In the presence of the non-neutrality of fiscal policy, the government would confidentially embark on the Keynesian anti-cyclical macroeconomic stabilization with the hope of experiencing a positive multiplier. Consequently, there is no hope for achieving non-Keynesian effects; fiscal contraction will end up necessarily in the deceleration of economic growth in the short run.

While the strong intervening role of liquidity constraints in consumption decisions is almost unanimously accepted among scholars, the issue of identifying a particular constraint and the measure of its

ultimate effect on current consumption has not yet gained a wide popularity in micro-based macroeconomics. The explanation for this negligence can be probably found in the serious challenges regarding the measurement of specific constraints. Assessing the share of population who suffer from liquidity constraint is not an easy task, because constrained households cannot be observed directly. The general technique for measuring liquidity constraint is to use some suitable *proxies*, thereby indirectly grasping the share of constrained households. In empirical works, the measures of the depth of financial intermediation play the role of proxy the most often. The hypothesis is straightforward: the deeper is financial intermediation, the less is the chance for experiencing liquidity constraint. The deepening of financial intermediation can in turn support the more effective working of the PIH model, giving a chance for non-Keynesian effects to occur in times of fiscal contraction.

Jappelli (1990) for instance used a data set of *rejected individuals* who were applying for credit but failed (the so-called “rejected customers”), and supplemented it with the share of those consumers who were simply afraid of applying for credit and therefore simply abstained (the *discouraged borrowers*). Based on these two indicators, the author found that according to a 1983 survey of American households, approximately 19 per cent of the population was rejected or discouraged, that is, they definitely suffered from a liquidity constraint.³² The explanations for being rejected or discouraged from borrowing formed a wide spectrum; reasons included the following: lack of established credit history (applicants were too young for instance),³³ insufficient credit record or bankruptcy,³⁴ low level of income or assets, etc. Table 3.1 provides more information on the American patterns of individual borrowing constraints. The tendencies speak for themselves. Current

³² Using a different method—similar to that of Campbell and Mankiw (1989)—, Jappelli and Pagano (1989) also found the same ratio for the US. The authors used a sample of OECD countries in their estimation and placed the countries into three categories accordingly. Sweden and the US belonged to the first group with the lowest excess sensitivity to current income (20 per cent). The UK and Japan were found to have a 30–40 per cent ratio of constrained individuals. This ratio was above 50 per cent in Italy, Greece and Spain.

³³ Almost one-quarter of the rejections fell into this category.

³⁴ Accounted for another one-fifth.

income, wealth status and age seem to be the most obvious candidates for explaining why people suffer from liquidity constraint. Low wage earners, relatively low savers and young people have to base their consumption more often on current income than other people.³⁵

Table 3.1 Reasons for credit constraints

Variable	Total	Rejected applicants	Discouraged borrowers	Unconstrained borrowers
Income	26.15	18.13	16.45	28.16
Net wealth	71.54	30.06	20.26	82.09
Age	44.97	35.41	35.76	47.17
Unemployment	0.08	0.14	0.15	0.07
Homeownership	0.61	0.35	0.26	0.68
Number of cases	2971	370	193	2408
% of cases	100	12.45	6.50	81.05
% of income held	100	8.63	4.09	87.28
% of wealth held	100	5.20	1.80	93.00

Source: Jappelli (1990).

Remarks: Data are from the 1983 Survey of Consumer Finances. The data show averages. Income and wealth are measured in thousands of 1982 dollars. Income is family gross income from all sources earned in 1982. Homeownership and unemployment are shares of the total.

In another paper, Jappelli and Pagano (1994) found dramatic differences in the degree of access to credit markets in a cross-country analysis of OECD countries. The authors assessed the degree of liquidity constraint by measuring (i) the volume of consumer credit available to households (as a ratio to the net national product); and (ii) the own down-payment in case of purchasing a house. As far as consumer credit is concerned, a huge variance was detected in the data among countries in the eighties starting from a negligible amount of 0.1 per cent in Greece, 1.5 per cent in Portugal or 2.5 per cent in Italy, contrasted with

³⁵ Jappelli's (1990) technique of directly estimating the share of the liquidity constrained population is appealing but costly to implement. In the Consumer Expenditure Survey he used, individuals were asked whether they had been turned down by lenders while asking for credit or had received less than what they originally applied for. Instead of such a direct estimation, authors use indirect proxies, such as the volume of savings or net wealth, which, however, can result in serious under or overestimation.

15 per cent in Canada or in the US and an extraordinarily high value for Sweden, 31.6 per cent. Interestingly, data over time show a significant increase in the degree of access to consumer credit. Down payments reveal the same patterns: in the eighties Greece, and Portugal (along with Japan) still required around 40–50 per cent of the total value of the purchased house to pay down, while it was extremely low in any comparison in the US (10 per cent) and more interestingly in Ireland (10 per cent) and in Denmark (5 per cent), the textbook cases for non-Keynesian effects. Moreover, in the time of the experienced expansionary fiscal consolidations, Ireland (1987–89) had a consumer credit ratio of 8.6 per cent compared to 6.1 in the seventies (positioning the country in the middle class of countries, which was not bad for a laggard in those days); while Denmark reflected 15 per cent in both decades.³⁶

Albeit it is hard to come up with unquestionable statements, intuitively, in case of a low level of consumer credit or high value for down payment, the chance for a dampening of consumption will increase—or putting it in other words: forced (national) savings will rise. In Jappelli and Pagano's (1994) regression analysis, a 1 per cent increase in consumer credit reduced savings by 0.3 per cent, while a 1 per cent decrease in down payment forced savings to be reduced by 0.2 per cent (results are statistically significant). To extend their findings to the topic of non-Keynesian effects, it can be argued that a higher accessibility to consumer credit or a lower down-payment when purchasing a house, that is, a deeper financial intermediation, may induce people to react more intensively to changes in permanent income, thereby allowing for the experience of expansionary effects in times of fiscal consolidation.³⁷

³⁶ More recent developments on financial intermediation and credit availability in former cohesion countries will be discussed in some length in section 5.4.

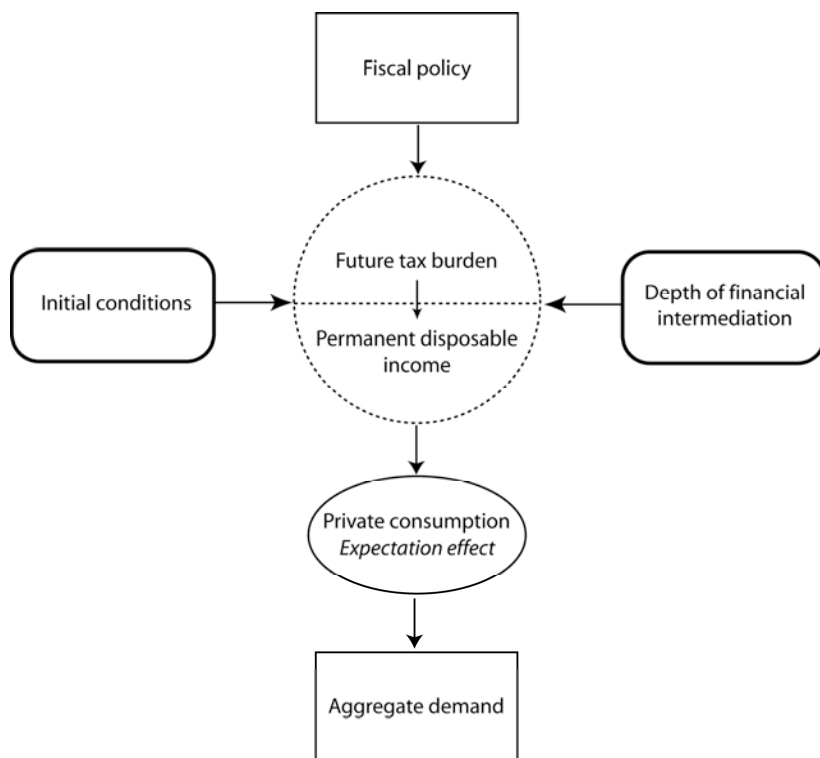
³⁷ For sure, liquidity constraint might not be the single reason for the excess sensitivity of consumption. Jappelli and Pagano (1989) also named the relatively low demand for loans as a possible reason for excess sensitivity, however, they did not attach too much significance to this interpretation. In fact, they claimed that “[o]n the whole, the evidence suggests that interest wedges and demand factors can hardly explain the international pattern in the recourse to consumer credit and mortgage loans. This pattern resulted instead from different degrees of rationing by financial intermediaries” (ibid. 1089).

Clearly, the relationship between the depth of financial intermediation and liquidity constraint is hardly disputable: both intuition and empirical studies suggest a positive correlation between the two. However, the ultimate aim of this section was to justify that non-Keynesian effects on the one hand and liquidity constraint on the other hand are hard to match. The depth of financial intermediation has played the role of a proxy by assessing the degree of credit constraint.

Before concluding this part, therefore, it is high time to underline the clear difference between (i) what the theory and a deductive analysis suggests concerning non-Keynesian effects; and (ii) what empirical studies conducted on non-Keynesian effects on the one hand and liquidity constraint on the other hand imply.

(i) By the deconstruction of the expectational view of fiscal policy on the one hand and consumption theory on the other hand, it has become possible to reach a number of significant conclusions. The most important theoretical inference has been the following: liquidity constraint in fact compels individuals to behave as it is predicted by the Keynesian consumption function, that is the presence of liquidity constraints may lower the chance for a shift in agents' behavior from the Keynesian to the Ricardian (or vice versa). More to the point: the prevalence of liquidity constraint does not support the appearance of non-Keynesian effects. Importantly, this is an inference that has been drawn *deductively* by having deconstructed modern consumption theory and the expectational view of fiscal policy. Taking these considerations into account, what we can claim here is that since the deepening of financial intermediation might be able to lift liquidity constraint, it also may increase indirectly the likelihood of experiencing non-Keynesian effects in times of fiscal consolidation. Policy conclusions such as the need for deepening financial intermediation, especially the increase of accessibility of households to credit markets, may therefore prove to be valid on a normative ground. A modified version of one of the previous figures (Figure 3.3) on the assumed relation between fiscal policy and aggregate demand can be found in Figure 3.8 accordingly.

Figure 3.8 The effect of fiscal policy on aggregate demand III:
A new approach with some amendments



Source: own construction.

(ii) Turning to the empirical side of the problem, it would be a failure, however, to claim that countries with a relatively complex and deep financial intermediation will always conduct a successful fiscal consolidation where success means accelerated economic growth in the short term. It would also be misleading, however, to argue that an *underdeveloped* financial system necessarily prevents a country from experiencing accelerated growth following a fiscal adjustment. Ireland in the eighties with its relatively underdeveloped financial intermediation system is a good example for underpinning this. While with its relatively underdeveloped financial system in the late eighties Ireland was able to experience non-Keynesian effects, no such experiment was made either in the nineties or in the new millennium—times when the depth of financial intermediation increased dramatically in the country.

However, elaborating on the eighties, Giavazzi and Pagano (1990) made an interesting observation regarding the Irish case. According to the authors, among several other factors, liquidity constraint might have contributed significantly to the failure of the first Irish stabilization attempt in 1982–83: the cuts in public spending and especially the rise in taxes triggered an immediate decrease of disposable household income (causing a drastic fall in private consumption as well). The second Irish consolidation attempt between 1987 and 1989 was undertaken *after* the initiation of a wide-scale liberalization program in credit markets. Liberalization increased substantially households' ability to borrow in the anticipation of higher future wealth. The Irish example suggests therefore that it is not the level of financial depth what matters but its *dynamism*.³⁸

3.5 Summary

In this chapter the first attempt has been made in order to explain the astonishing performance of some adjustment cases initiated in EU countries in the eighties and nineties. It has been shown that the so-called demand-side approaches maintain that the acceleration of economic growth in the year of fiscal contraction is basically triggered by the changing behavior of rational, forward-looking private agents.

³⁸ Several empirical studies have shown that financial market liberalization and deregulation can substantially reduce liquidity constraint. Bayoumi (1993)—using regional data—for instance conducted an empirical research on studying the relationship between consumption and financial deregulation in the UK in the eighties. His findings also confirm our hypothesis that financial deepening can significantly alter (i.e. increase) aggregate consumption. The increased competition in the financial market, along with the substantial fall of borrowing costs, “allowed consumers to react more to changes in their permanent income” (ibid. 536). As a corollary, the liquidity constraint was eased significantly due to market liberalization efforts: 60% of the population suffered from a borrowing constraint before the deregulation and only 30% had to face such a constraint after the increased competition. The positive relationship between a financial market deregulation and the easing of the liquidity constraint is certainly not just a European phenomenon. Among others, de Brouwer (1996) documented that financial liberalization and integration (both domestically and internationally) facilitated significantly consumption smoothing in Australia and in some selected East Asian countries.

Accordingly, the chapter identified those *circumstances* and *initial conditions* which can prove to be indispensable in altering individuals' expectations in a way to experience non-Keynesian effects and also elaborated on the main mechanisms through which these expansionary effects may emerge in the short term. By reviewing the most important concepts, the size of adjustment, the level and acceleration of debt ratio and government spending were identified as possible factors, triggering change in individuals' expectations regarding their future tax liabilities.

The theories provided a good ground for testing the relevance of these conditions/factors in triggering a(n unexpected) change by reviewing and applying the main findings of the empirical literature and combining them with descriptive data analysis. While the expectational view can prove to be an appealing and challenging explanation for non-Keynesian effects by combining both Keynesian and Ricardian behavior within the same models, the empirical justification of the theoretical approaches has remained indebted with a clear-cut support of the theory.

Next, a deep scrutiny of modern consumption theory has pointed out the importance of the underlying assumptions of the expectational view, especially the role of a lacking liquidity constraint, in experiencing non-Keynesian effects. In reality, credit constraint is a pervasive phenomenon even in developed countries that can make it indeed hard to experience the assumed switch in individuals' behavior since constrained people cannot base their decisions on their permanent income. Assessing the size and effect of liquidity constraint was implemented by scrutinizing the depth of financial markets. Based on these findings, what we can reasonably claim is that the prevalence of liquidity constraint does not support the appearance of non-Keynesian effects. It might not be too much but it can still point to the relevance of deepening financial intermediation, especially the increase of accessibility of households to credit markets.

In sum, while it was possible to clarify what conditions may *trigger* and *facilitate* the emergence of expansionary effects, further investigation is needed to fully explore the institutional conditions of experiencing non-Keynesian effects in certain countries and times. This will come in the next chapter.

CHAPTER 4

The Composition of Adjustment and the Structure of Labor Markets A Linear Approach to Fiscal Consolidation

Chapter 3 gave a comprehensive account of non-Keynesian effects but this might prove to be far from satisfactory from an economic policy viewpoint. Although consumption effects can be robust enough in some cases, they are effective only in the very short term. Moreover, they are conditioned on the coincidence of many initial and facilitating factors without which it is rather unlikely that consumers would increase their consumption in a time of fiscal contraction. As it has been shown in the previous chapter, among these factors liquidity constraint can be a particularly important obstacle to the emergence of non-Keynesian effects. Moreover, while demand-side theories are theoretically appealing, the role of consumption channel is still lacking a strong empirical support.

Accordingly, a different explanation of non-Keynesian effects will be provided in the present chapter. The emphasis will shift from the demand side to the supply side. The focus of the analysis will be on investment and the intervening variable of the labor market, playing the role of the channel through which expansionary effects can occur. As opposed to the expectational view of fiscal policy, no attempt has been made to construct new theories in order to rationalize non-Keynesian effects on the supply side. Instead, supply-side approaches claim that there is indeed nothing surprising in the emergence of expansionary effects in times of fiscal consolidations: lowered costs will induce private investment to increase. Costs can be expected to be reduced, however, if fiscal consolidation follows certain patterns: only by cutting public expenditures in the general budget can an increased investment and economic growth be maintained in times of fiscal contractions. However, as it will be shown in this chapter, positive growth effects can be expected to occur only if the labor market, functioning as a channel, accommodates *efficiently* the induced changes.

Accordingly, first, the main tenets of the supply-side approach of non-Keynesian effects will be presented in section 4.1, followed by a collection of the basic characteristics of successful adjustments, by concentrating on the structure of the general budget. As it will be shown in section 4.2, only by cutting back politically sensitive items such as the public sector wage bill and household transfers can a persistent consolidation of the general government budget be guaranteed and moreover the short-term costs of fiscal contraction reduced. In section 4.3, the labor market and the wage bargaining structure will be scrutinized in order to clarify what institutional conditions should be met so that a cutback in expenditure is politically viable by inducing a positive reaction of private agents via increased investment activity. By elaborating on European experiences, the significance of facilitating factors, such as social pacts, will also be discussed in some length.

4.1 Linear effects on the supply side

Although the theoretical literature on the “perverse” effects of fiscal adjustment focused almost exclusively on private consumption in the nineties, there were a few exceptions such as Alesina, Perotti and Tavares (1998), who have pointed out that even without a too detailed and deep scrutiny, it is tempting to realize that increase in *investment* contributed largely (in fact, disproportionately so) to the growth of GDP in times of expansionary fiscal consolidations. Alesina and Ardagna (1998) came up with supportive statistical evidence by having documented several cases of successful adjustment, providing a strongly different rationalization for the quick recovery in economic performance than that of the expectational view of fiscal policy.

This new approach proved to be highly sceptical to the expectational view of fiscal consolidation, discussed in the previous chapter. Although in theory wealth effects and consumption might be a channel in the realization of non-Keynesian effects, authors critical to the expectational view often found that the growth rate of consumption is not significantly different in successful and unsuccessful consolidations—while investment differs enormously. Authors add also that the economic expansion realized after (or even during) fiscal consolidation via the consumption channel will necessarily prove to be short-lived. Contrary to such a short-lived effect, investment may be accumulated

in the longer term as well, providing a solid ground for expansionary fiscal consolidations.

The shift in academic attention did not come without antecedents, however. Following the influential article of Alesina and Perotti (1995) on the necessity of cutting back politically sensitive items of the general budget such as the public sector wage bill and household transfer in order to restore fiscal balance, scholars turned immediately their attention to “[t]he interesting question ... [of]: what are the *channels* through which the budget cuts that the paper [of Alesina and Perotti] identifies as critical for ‘success’ induce an expansion in output?” (Giavazzi, 1995:241).¹ Casella (1995) raised the importance of political commitment of policy makers when implementing tight fiscal policy via spending cuts, a point further strengthened by Perotti et al. (1998), who argued that the sustainability of public finances should result in regaining control over the budget. Authors also emphasized the relevance of accompanying policies such as monetary ease or devaluations, etc.—see especially Giavazzi and Pagano (1990), Hagen et al. (2001) and McDermott and Westcott (1996).

Accordingly, as early as 1996, Alesina and Perotti (1996a) repeated their analysis but turned to the growth consequences of adjustment this time and tried to explicitly link composition to economic performance. They argued that it was not only the persistence of adjustment but also macroeconomic outcomes such as growth, unemployment and investment that could be related to composition. Furthermore, studying seven European cases with large adjustments, Alesina and Perotti (1996b) confirmed their earlier claims: countries implementing adjustments via spending cuts do not perform worse regarding economic growth than those which embark on a revenue-based fiscal tightening—if something then the opposite is true.²

¹ Emphasis added.

² Interestingly, the two authors initially used a very cautious wording: “models which emphasize the effect of the composition of the adjustment on unit labor costs in unionized and open economies are *at least as relevant* empirically as models which focus upon credibility and wealth effects.” (Alesina and Perotti 1996a:40. Emphasis added.) Later on, however, they vindicated the claim—along with others—that supply-side explanations are superior to other (i.e. demand-side) theories in explaining expansionary fiscal consolidations. See especially Alesina et al. (2002).

Contrary to the many novel statements, supply-side approaches do not attempt to theorize expansionary fiscal consolidations since authors are convinced that “there may be nothing special in the behavior of investment at the time of expansionary fiscal adjustments... The estimated effects of spending and taxes on investment imply that the different composition of the stabilization package can account for the observed difference in investment growth rates” (Alesina et al. 2002:576). That is, the emergence of expansionary effects of fiscal consolidation simply follows common sense reasoning: lower costs, induced by spending cuts in public wages and other welfare items, make investment more profitable and desirable. The authors continue by claiming that “[w]e do not find significant ‘non-linearities’ or structural breaks in the reaction of investment around large fiscal consolidations. This result suggests that we may not need ‘special theories’ to explain episodes of large fiscal adjustments” (ibid. 576). They argue accordingly that there is no need to distinguish between *good times* and *bad times*. Investment always reacts in the same way. If adjustment is conducted by cutting back politically sensitive items of the budget, they would likely to be permanent and growth-enhancing.³

In general, supply-side approaches claim that the *increase* of public spending may have an adequately large negative effect on investment even beyond the well-known crowding-out phenomenon. The public sector wage increase will create wage pressure in the private sector, too. Higher taxes also create a higher pre-tax wage demand in both unionized and competitive labor markets. In a neoclassical model, a tax increase would simply reduce individual labor supply. However, in real world economy, labor is rather inflexible, therefore any increase in taxes will be outweighed by a rise in wage-demand. Consequently, Alesina and Ardagna (1998:516) claim: “the composition of the adjustment appears as the strongest predictor of the growth effect: all of the non-expansionary adjustments were tax based and all of the expansionary ones were expenditure based.” Alesina, Ardagna, Perotti and

³ If there is no need to divide categorically the state of the world into two, there is obviously no reason to speak about perversity or non-linearity of fiscal policy either. In fact, supply-side approaches claim that what is happening is simply a straightforward, or “linear” story: consolidating the budget in the right way may guarantee growth in the economy in the short run already without the assumption of a switch in the behavior of agents from a Keynesian manner to a Ricardian one.

Schiantarelli (2002) on OECD countries also demonstrate that fiscal contraction may have the effect of increasing welfare if it triggers government wages, and to a lesser extent, but still significantly, the transfers to households. The competitiveness and the profit prospects of the private sector improve when the government cuts back on these budgetary items.⁴

By cutting back the transfer programs, the number of public sector employees and their compensation, labor market becomes more efficient, making the costs of labor relatively lower. The emphasis was put expressively on the supply side. Accordingly, the general attention regarding the channel through which the expansionary effects can spread should be redirected to the structure of the *labor market*. The attention drawn to the structure of the labor market distinguished this stream of research unequivocally. By concentrating, however, on the labor market, a rather new conceptualization of the phenomenon of non-Keynesian effects occurs, since—admittedly—labor markets are highly imperfect in democracies, that is, supply-side explanations can build their arguments on imperfect institutions such as unionized labor markets, rigid labor supply or imperfect competition.⁵

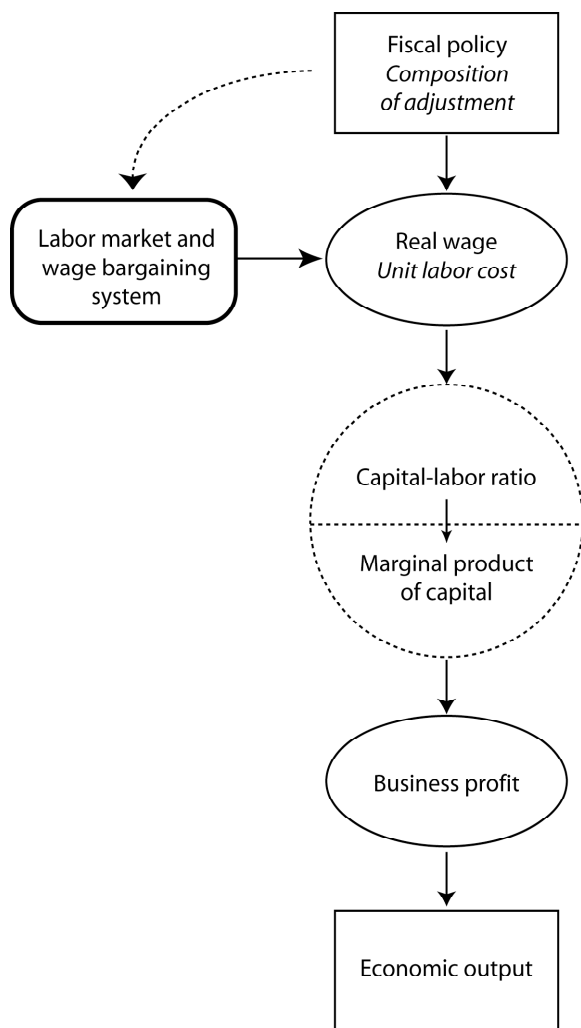
Modelling the mechanism of the emergence of expansionary effects of fiscal contraction within the supply side framework requires firms—the ultimate units of decision-making—to be rational and forward-looking. Firms try to maximize the expected present value of future cash flow and decide on the current level of investment accordingly. Profit and investment depends on the marginal product of capital that is in turn determined by the ratio of capital and labor. Any decline in real wage will reduce the capital–labor ratio and increase therefore the marginal product of capital, increasing profit and investment. The reaction of real wage to changes in fiscal policy depends, however, on the composition of adjustment. That is, changes in the public sector wage bill will alter the private sector’s wage and profit expectations, too. However, such a change can happen only if the labor market allows fiscal

⁴ The authors estimated the effect of a 1 per cent increase (in GDP) of public expenditures and revenues on the marginal propensity to investment. They found that the immediate effect of a wage increase is half per cent (negative), while the cumulative effect (up to five years) is more than 2.7 per cent.

⁵ For a more detailed account, see section 4.3.

policy to exert influence on private actors' decisions and thereby on economic outcomes. (The flow diagram can be seen in Figure 4.1.)

Figure 4.1 The effect of fiscal policy on economic output:
A supply-side interpretation



Source: own construction.

By applying a linear approach to non-Keynesian effects, *economic growth* can be expected in times of fiscal contractions only if both the composition of adjustment and labor market structure are designed in a desired way. Nevertheless, it needs to be clarified what “desired” means exactly, that is, (1) how adjustment should be implemented; and (2) what sort of labor market structure and/or wage bargaining mechanism is necessary—although possibly not sufficient in itself—to give economic output a chance to accelerate in times of adjustment in the short run.

4.2 The first step: composition matters—restoring fiscal balance

The main concern of economic policy of the eighties and nineties was how to restore fiscal balance, how to eliminate deficit bias. The reason for the shift was two-fold. On the one hand, the perspective of the potentially unsustainable debt ratios in some countries made it necessary to induce changes in the course of fiscal policy from the late seventies onwards. The real interest rate exceeded the growth rate of output and culminated in skyrocketing debt-to-GDP ratios. On the other hand, the launching of the single currency in Europe, along with the preparation, ratification and implementation of the Maastricht Treaty, put fiscal policy in the highlight of theory and policy research. The message of Maastricht was straightforward: careful management of public finances is needed, in order to achieve a full growth potential without compromising macroeconomic stability.⁶ This shift in economic thinking has revaluated the need for applying a disaggregate view in public finances, that is, a careful analysis of both the spending and the taxation side of the general government.

Originally, the Keynesian anti-cyclical policy used fiscal policy as the fundamental device in short-term economic stabilization. Nevertheless, contrary to the original aims of the Keynesian recipe—managing aggregate demand across cycles—fiscal policy followed a highly asymmetric nature in Europe after the decades of the Second World War. Governments eagerly applied fiscal spending in the years of economic slowdown but forgot to accumulate surpluses in periods of boom

⁶ Sustainability of public finances means that the present value of the sum of the future expected revenues covers all the present and the future liabilities of the state.

(European Commission 2000). It is worth emphasizing, however, that it was not always the case that governments could produce deficit year by year, independently of the business cycles. Before the sixties, practically no written formula was needed in order to attain a balanced budget position in the medium run. Buchanan (1997) documented this brilliantly. It is a relatively recent phenomenon that a government can finance its spending by producing deficit in both “good” times and “bad” times. Before the sixties, the norm was that deficit could be the natural result of extraordinary circumstances and exogenous shocks such as wars or serious recessions. Permanent deficit lasting throughout the cycles was atypical.⁷

The asymmetric nature of fiscal policy in OECD countries, however, can be touched upon in another aspect, too. Admittedly, both loose and tight fiscal periods could be observed (and almost in the same number), but the character of these fiscal episodes were qualitatively different. While in very loose times governments mainly increased expenditure, in case of fiscal contraction it was mostly taxes which were raised. As a corollary, the size of state increased automatically without bounds in the last few decades, and the weights attached to the different budget items showed a significant rearrangement: the share of non-wage government consumption fell, while social transfers and welfare expenditures increased dramatically—see Table 4.1.

Table 4.1 The evolution of expenditure and taxation
in OECD countries

	Social expenditure		Government consumption		Labor taxation	
	1960	1990	1960	1990	1965	1990
Average*	8.3	15.3	15.1	17.3	13.2	21.2
Growth rate**	85		14.9		60	

Source: Alesina and Perotti (1997).

Remarks: *weighted average (weights in 1980 GDP); ** percentage.

⁷ The political economy literature on permanent deficit has proliferated substantially in the last few years. See especially Grilli, Masciandro and Tabellini (1991), Hallerberg and Hagen (1999) and Persson, Tabellini and Roland (2000).

4.2.1 Composition matters—in general

In the initial phase of research on the composition of adjustment, scholars were interested only in the immediate and direct effects of consolidation: the elimination of deficit bias. Originally, the macroeconomic consequences of consolidation such as economic growth were not regarded as part of the research program, therefore the initial question was how composition could be related to the *persistence* of adjustment where persistence meant a significant (and lasting) reduction in deficit and/or debt. However, very soon, as a response to the increased demand for explaining some spectacular adjustment experiences, such as Ireland's, the study of composition has also been extended to explain non-Keynesian effects. First, we will focus primarily on the original problem: the relationship between composition and deficit/debt reduction, while the scrutiny of composition and expansionary effects will come in the next section.

In a sample of OECD countries between 1960 and 1992, Alesina and Perotti (1995) found that in the case of *permanent* adjustment four-fifths of the deficit reduction took place on the expenditures side, and even half of it was attained by cutting back on two politically sensitive items: public sector wage expenditure and households transfers. Unsuccessful attempts, however, demonstrate that politically sensitive transfers and the public sector wage bill remained untouched. Instead, as it was shown by Alesina and Perotti (1996a) in another study—and also confirmed by Perotti et al. (1998)—on average two-thirds of the cuts in expenditure fell on public investment. (In successful consolidations, cuts in capital spending were around one-fifth only.) The numbers on public investment clearly indicate the claim that the lack of *political commitment* to permanent consolidation drives opportunistic politicians to take the easy way out: cuts in capital spending may have no political costs in the short term and even the negative economic consequences will take effect only after several years. Regarding the revenue side, it may be stated that success can be expected only if the government refrains from increasing taxes. Perotti et al. (1998) came to the conclusion that in the case of an unsuccessful consolidation, the increase of taxes accounts for more than 80 per cent of the total (failed) adjustment efforts (on average).⁸ They emphasize therefore that “deci-

⁸ The term “successful” is used here to refer to the persistence of adjustment and not to its growth-enhancing capabilities.

sive action to stop and reverse expenditure growth is a key element of successful consolidation” (ibid. 15).

The structure of public spending gains further importance when we also take into consideration our main findings from Chapter 2 on the stylized facts of major EU-14 adjustments: in the case of both successful and unsuccessful adjustments, the size of consolidation was almost identical in the year of consolidation (approximately 2.5 per cent of the GDP, which is generally found in other empirical studies, see for instance Giavazzi and Pagano 1995 or Giudice et al. 2003). The lesson is straightforward: it is not the size of the adjustment, but its quality, i.e. its composition, that is the decisive factor in restoring fiscal balance. The fact that a government is able to reduce the deficit by some percentage points does not mean yet that it has implemented a persistent and successful adjustment.⁹ The dispute on “size” versus “composition” gains significance especially if it is taken into account that the standard textbook approach is to focus on the *size* of consolidation only, while composition is left in the dark. Nevertheless, from the point of view of economic policy, the real challenge is manifested in *composition* (as opposed to the size), since this is where politically sensitive decisions are taken, i.e. who will bear the burden of adjustment. The effects of the composition of adjustment are summed up in Table 4.2.

Hagen et al. (2001) extended the focus of research on persistent consolidations to the *economic environment* in which adjustment occurred. They found that initial conditions such as high debt helps predicting the timing of adjustment and moreover it is more likely that consolidation in times of high debt is implemented on the expenditure

⁹ It is worth emphasising, however, that these authors always refer to adjustments of at least 1.5 per cent of the GDP or larger (see Table 2.1 in Chapter 2). Accordingly, this means that our claim should be modified as follows: beyond a certain level, size does not matter anymore, instead it is the composition which may determine success. In fact, the political commitment of parties/governments to implement fiscal consolidation is often measured by the size itself. If a government wants to signal its determinacy, it has to initiate a sizable, robust adjustment; otherwise markets do not consider the attempt as credible. Additionally, the importance of the size of adjustment cannot be neglected if the task is for instance to abide by the rules of the Stability and Growth Pact in a country where the *initial* level of deficit is much above the required “close-to-balance or in surplus” position.

Table 4.2 The characteristics of successful and unsuccessful stabilization attempts

Successful adjustment	Unsuccessful adjustment
• In general, reduction of expenditures; • In particular, the withholding of welfare transfers and wages of the public sector; • Reduction in the number of public sector employees; • Increase of revenues is of secondary importance; household incomes are not taxed additionally, instead the broadening of the tax base occurs.	• In general, wide-scale tax increase; • In particular, the increase of the taxes on household incomes and social security contributions; • The cutting back of expenditures to only a small extent (cuts fall on public sector investments almost exclusively); • The reduction of the politically sensitive elements does not take place at all.

Source: own construction.

side. However, the predictive power of economic environment becomes rather weak when it is considered together with the composition of adjustment—a finding which probably strengthens the claim that albeit initial conditions may matter (a claim popularized by demand-side approaches of non-Keynesian effects) but their explanatory power cannot be detached from other factors, i.e. from the quality of adjustment. Concerning other accompanying circumstances, the authors claim that the change in monetary policy has no significant effect on the probability of success of fiscal consolidation, while the relative performance of a country (as compared to others) might have an influence. McDermott and Westcott (1996) also suggest that fiscal consolidation implemented at a time of weak international economic performance does not enhance the probability of success either.

A consensus view on fiscal consolidation seems to emerge: cutting back politically sensitive items should be a constitutive part of any consolidation attempt which aims at restoring fiscal balance and sustainability. Hesitance to tackle politically sensitive items of the budget

results in unsuccessful attempts, meaning that the problem of unsustainable public finances has not been solved but only postponed. Accordingly, *political decisiveness* can prove to be crucial in the success of fiscal adjustment. Without the political willingness of policy-makers to turn to the expenditure side of the general budget, the ultimate effects of any stabilization efforts may strongly be questionable.

4.2.2 The composition of fiscal adjustment—some evidence from the EU-14

Introducing our next topic, an in-depth scrutiny of permanent and expansionary fiscal retrenchments¹⁰ in the EU in the last few decades, we return to our sample of EU-14 countries, introduced in Chapter 2, with the aim of testing the main hypotheses of the *composition* literature. The descriptive data analysis serves once again only as a guideline and does not attempt to provide fully-fledged answers concerning the relationship between the composition of exceptional fiscal episodes on the one hand and debt-reduction and growth-effects on the other hand. Nevertheless, the short analysis—by comparing sample means—may reveal what type of consolidation is worth implementing if the aim is to achieve not just deficit and debt reduction but also to prevent the economy from falling into recession, as it is predicted by the standard Keynesian theory.

The study performed on our sample in Chapter 2 concluded with the observation that size in itself cannot determine whether a fiscal consolidation will have permanent effects or whether a country can avoid the usual slowdown in economic activity. In fact, there was no significant difference in size between successful (that is, debt-reducing) and unsuccessful, and expansionary and contractionary fiscal adjustments. Hopefully, the decomposition of main fiscal aggregates will reveal the main factors which may be responsible for providing different outcomes in macroeconomic variables.

In the following data analysis, however, we do not run into a detailed decomposition of fiscal aggregates yet, since this is left to the case studies of some selected countries in section 4.2.3. Instead, the focus

¹⁰ Definitions of successful and expansionary fiscal consolidations are given in Chapter 2.

of the descriptive analysis will be to search for some indication whether the type of adjustment, i.e. expenditure-based or revenue-based, is a good predictor for the macroeconomic consequences of fiscal consolidation. Accordingly, the 58 episodes identified in Chapter 2 were grouped into three categories: expenditure-based, revenue-based and mixed adjustments. Certainly, fiscal consolidation is usually pursued by both expenditure cuts and revenue increases, however, a distinction is easily made if the magnitude of changes on the two sides are considered.

Definitions:

A fiscal adjustment was characterized as *expenditure-based* in our sample of EU-14 if the decrease in total expenditures (from year $t-1$ to t) was 30 per cent larger than the increase in revenues (from year $t-1$ to t).

Accordingly, a fiscal adjustment was characterized as *revenue-based* if the increase in total revenues (from year $t-1$ to t) was 30 per cent larger than the decrease in expenditures (from year $t-1$ to t).

And a fiscal adjustment was characterized as *mixed adjustment* if the change in the greater parameter (from year $t-1$ to t) was larger by 30 per cent at the most than the change in the other variable (from year $t-1$ to t).¹¹

Admittedly, the above categorization is not without problems. Using different definitions or different measures for expenditures and revenues can provide diverging results. As far as the fiscal measure for expenditure and revenue is concerned, the measure of total expenditure and total revenue have been used in the selection process first, and then these results were contrasted with the findings under a different measure, namely current expenditure and revenue. The numbers are taken from the OECD (2005a), but in case of ambiguity those of the EC (2005) have also been used. It turns out that the total number of observations (58) followed the distribution given in Table 4.3.

¹¹ There is no general agreement on how expenditure-based, revenue-based and mixed strategies can be defined. Authors usually apply arbitrary definitions. In our case, the 30 per cent difference might be low indeed but it allows us to differentiate between expenditure- and revenue-based consolidations relatively easily and to reduce the number of in-between cases substantially.

Table 4.3 Categorization of fiscal consolidations

Type of adjustment	Number of observations	% of the total
Expenditure-based	19	34
Revenue-based	31	55
Mixed	6	11
Total	56	100

Source: own calculations.

Remarks: the number of total observations in the table is two less (56) than what it should be (58). However, two episodes were simply not possible to put into any of these categories because the data showed considerable contradictions.

The share of revenue-based adjustments stands out remarkably from the field; more than half of the episodes were initiated on this side of the general budget. Expenditure-based consolidations have a share of one-third only, while—probably due to the strict definition—only every ninth adjustment could be described as mixed. The fundamental question is whether some systematic regularity could be deduced from these numbers concerning the macroeconomic consequences of adjustment. In Chapter 2, two such consequences were studied: i) the change in the debt-to-GDP ratio; and ii) the growth-effects of adjustments. A widely-used hypothesis in the relevant literature is that only a cut in public spending can result in permanent debt-reduction. The question is therefore whether debt-reducing fiscal adjustments do really originate from the group of those episodes where the government was willing to cut back fiscal expenditures.¹²

The findings based on our sample are gathered in Table 4.4 and indeed speak for themselves. 11 out of the total 19 expenditure-based consolidations proved to be successful, while only 3 out of 30 could produce a major and permanent reduction in the debt ratio in case of revenue-based adjustments. The number of mixed strategies is too low to come up with robust results, although our sample supports the intuition: in half of the cases, governments could reduce the debt ratio by applying a mixed fiscal strategy. In sum, it is not an exaggeration to

¹² *Definition 2* of Chapter 2 has been used here for permanent (or debt-reducing) adjustment: a fiscal adjustment in year t is permanent if the gross debt-to-GDP ratio is at least 5 percentage points of the GDP lower in year $t+3$ than in year t .

claim that if the objective of fiscal adjustment is to stop further acceleration in the debt-to-GDP ratio, then governments should embark on an expenditure-based consolidation.

Table 4.4 Systematic characterization of adjustments I:
The relationship between the type of adjustment and persistence
of consolidation

Type of adjustment	Permanent consolidation	Non-permanent consolidation	Total
Expenditure-based	11 (58)	8 (42)	19 (100)
Revenue-based	3 (10)	27 (90)	30 (100)
Mixed	3 (50)	3 (50)	6 (100)

Source: own calculations.

Remarks: figures are number of observations; in brackets: share of observations.

The total number of observations is 55. Two data points fell out of the total 58 as it was pointed out earlier because of the inconclusive categorization attempts. One more episode was left out because its three-year-long affect on debt reduction cannot be measured yet (Ireland 2003). Nevertheless, this episode belongs to the group of revenue-based adjustments and according to projections, Ireland presumably provides a decline, but not enough to have it qualified as a permanent attempt.

Although Table 4.4 does not provide additional data on the expenditure side, it is worth noting that successful expenditure-based consolidations focused almost exclusively on the reduction of *current spending* and left public investment untouched in our sample. Unsuccessful adjustments focused, however, almost exclusively on cutting public investment and left the current expenditure untouched.

In passing, the relationship between the type of adjustment and its effect on economic growth will be scrutinized. According to Table 4.5, achieving an expansionary fiscal consolidation can be based either on spending cuts or revenue increase. It seems that even revenue-based and mixed strategies can prove to be useful sometimes in providing non-Keynesian effects. 9 out of a total of 31 episodes could support the emergence of expansionary effects in case of increasing taxes in times of fiscal consolidation. Nevertheless, expenditure-based adjustments can induce non-Keynesian effects to evolve with a much higher probability. If a government is willing to cut expenditures, there is a more than 50 per cent chance to experience the desired expansionary effects

in times of fiscal contraction. As far as mixed strategies are concerned, the relatively low number of observations makes it hard to come up with any conclusive suggestions. Nevertheless, from a broad perspective, mixed fiscal strategies perform much better than purely revenue-based consolidations if the aim is to experience non-Keynesian effects.

Table 4.5 Systematic characterization of adjustments II:
The relationship between the type of adjustment and its output effects

Type of adjustment	Expansionary fiscal consolidation	Contractionary fiscal consolidation	Total
Expenditure-based	10 (53)	9 (47)	19 (100)
Revenue-based	9 (29)	22 (71)	31 (100)
Mixed	3 (50)	3 (50)	6 (100)

Source: own calculations.

Remarks: figures are number of observations; in brackets: share of observations.

The total number of observations is 56. Two data points fell out of the total 58 as it was pointed out earlier because of the inconclusive categorization attempts.

It is highly characteristic what type of adjustment was chosen by the individual countries. Ireland and Belgium used expenditure-based adjustments throughout the eighties, which was copied by the UK in the nineties. Italy, Portugal and to a lesser extent Denmark and Austria preferred revenue-based consolidations. Greece pursued mixed strategies in the nineties. Finland, the Netherlands and Sweden applied a switching strategy: expenditure- and revenue-based adjustments were used alternately.

At this point it is worth summarizing the main tenets of the statistical analysis. It provides the following conclusions:

- (i) more than half of the adjustment episodes were pursued by increasing revenues, and only one government out of three was willing to initiate fiscal consolidations by cutting back public spending;
- (ii) permanent adjustment was achieved by expenditure-based adjustment in two-thirds of the cases, while 70 per cent of the unsuc-

cessful (non-persistent) consolidations were implemented by revenue-based adjustments;

- (iii) expansionary effects in times of fiscal contractions can be experienced in both revenue- and expenditure-based consolidations, however, cutting back expenditures can guarantee the occurrence of non-Keynesian effects with substantially higher probability; and
- (iv) nevertheless, while the chance for experiencing permanent and expansionary consolidation is much higher if the government implements an expenditure-based adjustment, this by itself does not guarantee that every and each spending-based consolidation will decrease the debt-ratio significantly and provide non-Keynesian effects. Further analysis is needed to explain this puzzle.

In sum, *composition*, even at such a relatively high level of aggregation (expenditures and revenues), *does matter*. Nevertheless, these results should be taken with caution. We still need to ask ourselves why some spending cuts prove to be successful and expansionary while others fail. Naturally, the size of adjustment cannot be irrelevant to the macroeconomic consequences of consolidation. However, the size itself cannot be a good predictor of economic consequences; composition seems to fit this role better.

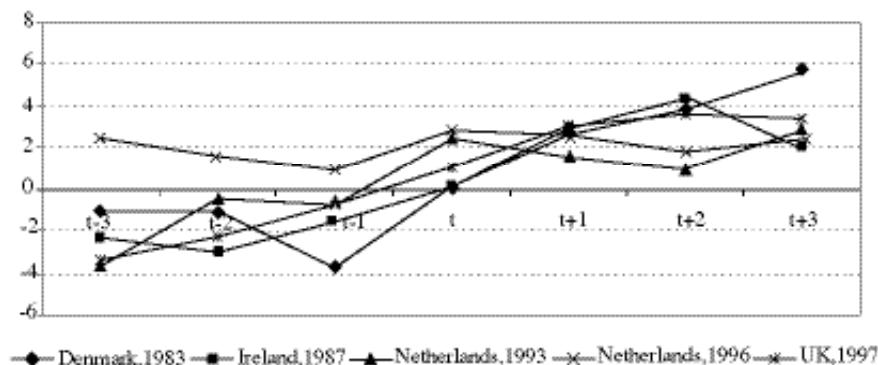
4.2.3 Country experiences

Sample means can be indicative in several respects, however, country case studies may contribute to a better understanding of how the composition of fiscal adjustment can produce significant changes in macroeconomic consequences, such as economic output. Four cases have been selected from our EU-14 sample, focusing on the eighties and nineties. The criteria for selection were the following: accelerated economic growth in times of fiscal consolidations, and a significant reduction of the debt-to-GDP ratio. In line with the main findings of section 3.2.3, the four case studies will be the following: Ireland (1987–89) and Denmark (1983–84)—the textbook examples of expansionary fiscal consolidations—plus the Netherlands (1993 and 1996) and Great Britain (1997–98). In Ireland (1987–89), the consolidation was initiated exclusively on the expenditure side, providing one of the most remark-

able fiscal adjustments in the EU in the last two decades. The spending reduction resulted in a strongly positive primary balance as early as 1988 and public debt was decreased by more than 10 percentage points between 1986 and 1990. In Great Britain, expenditure cuts played a central role also in the adjustment process. In addition to transfers, the freezing and reduction of government wages proved to be useful in stabilizing fiscal position, thereby providing a ground for economic growth already in the short-term. The Netherlands benefited from the Maastricht process of the nineties, which triggered two adjustment waves in the country. Nevertheless, some corrections had been already initiated in the eighties. Denmark is not a trivial case, in the sense that both revenue-increase and spending cuts contributed to the short-lived economic recovery during the mid-eighties as it has been already shown in section 3.2.3. Unfortunately for Denmark, a reversal evolved in its fiscal profile as early as 1987, resulting in a deteriorated fiscal balance. The evolution of the cyclically-adjusted primary fiscal balance in the four countries is portrayed in Figure 4.2.¹³

¹³ Admittedly, one of the most well-known fiscal consolidations was implemented in Sweden in the mid-nineties. The drastic changes in the fiscal course of Sweden were initiated from 1994 onwards which were, however, preceded by a strong devaluation of the Swedish koruna. Although revenues were also increased, the adjustment was initiated basically on the expenditure side: the general level of spending decreased by around 8 percentage points (in GDP) between 1993 and 1998. The government achieved a positive primary balance as early as 1996, putting an end to debt accumulation, too (in 2000 it was already below the Maastricht criterion with its value of 52.8 per cent, decreasing from its starting level of 73.9 per cent in 1994). Unfortunately, the Swedish episode did not prove to be non-Keynesian, therefore, it will not be discussed among our case studies. However, it is worth emphasizing that while the adjustment did not result in an immediate acceleration of economic growth in the country, the relatively low performance of the Swedish economy—showing a 0.7 average growth rate per year between 1991 and 1995—changed to a steady increase by climbing to 1.3 per cent in 1996, 2.4 in 1997, 3.6 in 1998, and peaking at 4.6 in 1999. That is, the persistence of the consolidation laid down the foundations of a sustainable economic growth in the country.

Figure 4.2 Primary government balance in selected countries (cyclically adjusted)



Source: own calculations based on the data set of OECD (2005a).

Remarks: percentage of potential GDP. Fiscal adjustment was adopted in year “t”.

Figure 4.2 indicates a general recovery in primary government balance in the selected countries. It can also be seen in the figure that the triggering year proved to be sign-changing in almost each case. The only exception is the Netherlands (1996), where the negative primary adjusted balance turned into positive in 1993 already, at the time of the first Dutch stabilization attempt. The fundamental question remains, nevertheless, which factors contributed to the change of sign in the adjusted primary balance. Was it a decrease in the current expenditure, or an increase in receipts that facilitated persistent and growth-supporting attempts?

4.2.3.1 Ireland (1987–1989)

After the first failed fiscal consolidation of 1982 in Ireland, the newly elected right-wing cabinet initiated an ambitious adjustment program in 1987, followed by several other supplementing economic measures. The consolidation—started in February 1987—was based *exclusively* on expenditure cuts, in fact, taxes fell slightly between 1987 and 1989 (see Table 4.6). Throughout these years, the total spending was decreased by 8.5 per cent of the GDP and revenues also declined by a couple of percentage points. The Irish government did not hesitate to drastically cut back the politically most sensitive items such as the wage bill of the public sector and household transfers. Both the business sector and

households suffered a significant reduction in direct payments: private businesses for instance had to face a 27 per cent nominal decrease (Perotti et al. 1998).

More importantly, between 1988 and 1989, the Irish government reduced the number of public servants by 9 per cent, which means that 30,000 people were made redundant. This was carried out not simply in the form of dismissals, but rather in the form of early retirement and by freezing recruitments. The fiscal consolidation program was supplemented with a wage agreement among social partners and the state in both the private and the public sector.¹⁴ One of the crucial elements of the wage agreement between social partners was that the claims on real wage increase could not exceed improvements in productivity. The significant lay-off proved to be politically sustainable because it involved a wide-scale tax reduction, and as a corollary, the private sector absorbed so enough to eventually decelerate unemployment rate. Additionally, the government spent a significant amount of money on re-training courses.¹⁵

It is worth mentioning, however, that an increase in employment and an overall recovery of the economy probably would not have been possible without a favorable international economic environment, especially in the case of the most important trading partners of Ireland, which boosted export. Besides, the acceleration of capital inflow via foreign direct investment also contributed to the positive growth effects. Capital inflow was also supported by the timely liberalization of capital accounts and the devaluation of the Irish pound in 1986—a point strongly emphasized by Giavazzi and Pagano (1990), too. In sum, the restored overall competitiveness of the Irish economy, along with the accommodative monetary and exchange rate policy were integral parts of the economic policy package of the right-wing cabinet.¹⁶

¹⁴ Boltho (2000) documented convincingly that the success of the Irish consolidation was based on both the composition of adjustment and social partnership.

¹⁵ Applying the estimates of Alesina et al. (2002) to the 1987-89 Irish adjustment, the drop in primary spending from 37.9 per cent (1986) to 29.7 per cent (1989) and the tax reduction from 37.6 per cent to 35.2 per cent together caused an estimated 2 percentage point increase in profits, making investment more attractive to private firms.

¹⁶ Among others, Barry (1991) and Bradley and Whelan (1996) are therefore rather sceptical to the Irish consolidation miracle, and instead they empha-

Table 4.6 The composition of fiscal adjustment, Ireland (1987–89)

	1986	1987	1988	1989	1990	1986–1990
Debt	113.0	114.1	109.8	100.4	94.1	-18.9
Balance	-10.6	-8.6	-4.7	-2.7	-2.8	+7.8
Current revenue	40.5	40.9	41.6	37.9	38.0	-2.5
Current expenditure	47.1	46.4	44.4	38.8	39.4	-7.7
Final consumption	18.7	17.7	16.4	15.3	16.5	-2.2
Compensation of employees	11.6	11.3	10.5	9.8	10.4	-1.2
Social transfers in kind	10.6	10.1	9.3	8.7	9.4	-1.2
Subsidies	1.9	2.6	3.0	1.2	1.1	-0.8
Interest payment	9.3	9.3	8.7	7.8	8.1	-1.2
Public investment	3.5	2.6	1.8	1.8	2.1	-1.4

Source: EC (2005).

Remarks: the data cover the years of the adjustment itself (i.e. 1987–89), plus one year before and after the consolidation was initiated.

Ireland initiated another fiscal consolidation just before the launch of the EMU project, in the mid-nineties. Since the economy experienced a continuous boost in economic activity and the country soon became one of the richest states in the EU, Ireland implemented a much less powerful and spectacular adjustment, however. Although there were some cuts on the expenditure side, this time the bulk of adjustment was initiated on the revenue side. A striking difference between the two adjustments in the late eighties and mid-nineties is in the cuts of subsidies and other transfers. While in the eighties it almost reached 8 percentage points, several years later it showed a less than 3 percentage point cut. The Irish experience demonstrates convincingly that following a serious and comprehensive stabilization program, whereby the ground was created for a decade-long spectacular economic performance, there was no need for the country to change the course of economic policy *drastically* later on.

size the relevance of the additional factors listed above as contributing towards the ultimate positive growth effects.

4.2.3.2 Denmark (1983–1984)

The Danish started the consolidation in the first half of the eighties, following a serious deterioration in fiscal performance, price stability, and economic activity. Public debt doubled within five years (before the consolidation occurred), and fiscal deficit got close to 10 per cent. According to our definition, Denmark initiated a revenue-based adjustment, although according to other authors, it is better to say that it embarked on a mixed strategy. While it is hard to judge whether the Danish consolidation was originally a revenue-based or a mixed strategy, the magnitude of changes shows that the increase in revenues was more than the decrease in spending.

For sure, besides revenue increase, the spending cut was unavoidable since the redistribution achieved an extremely high ratio in the country: 60% of the GDP by 1980. Similarly to Ireland, transfers and compensation to employees were decreased—although at a more moderate rate. In concrete terms, the earlier practice of price indexation of welfare spending was given up and maximum ceilings on some welfare cash benefits (such as sickness) were introduced. Wage-freezing, drastic stop on pension payments and unemployment benefits contributed to the success of the consolidation program, too. Wage-indexation was suspended until 1987. The determination of the government can be touched upon by contrasting current spending cuts with cuts in public investment: the ratio of current expenditure cuts versus public investment was around 5. Still, the balance of overall expenditures did not improve due to the steep increase in the payment of interest. The dramatic recovery in fiscal balance (which turned into a sufficit due to fiscal adjustment measures as early as 1985, that is a 10 per cent of GDP recovery was attained by the right-wing government) was therefore mostly due to the significant increase of direct taxes (both on business and households) and social security contributions. Revenues increased by 7 per cent of the GDP between 1981 and 1988, causing a serious increase in the tax burden. Additional data are provided in Table 4.7.

Table 4.7 The composition of fiscal adjustment, Denmark (1983–84)

	1982	1983	1984	1985	1982– 1985
Debt	65.2	75.0	79.0	75.9	+10.7
Balance	-8.3	-6.4	-3.6	-1.4	+6.9
Current revenue	50.2	52.3	54.0	54.9	+4.7
Current expenditure	55.2	55.0	55.6	54.5	-0.7
Final consumption	28.5	27.7	26.4	25.7	-2.8
Compensation of employees	19.3	18.9	17.8	17.3	-2.0
Social transfers in kind	19.7	19.3	18.1	17.7	-2.0
Subsidies	1.9	1.9	1.7	1.6	-0.3
Interest payment	5.7	7.7	9.2	9.5	+3.8
Public investment	2.4	2.0	1.9	2.0	-0.4

Source: EC (2005).

Remarks: the data cover the years of the adjustment itself (i.e. 1983–84), plus one year before and after the consolidation was initiated.

The judgement of the Danish “miracle” is not without doubts, however. On the one hand, the favorable (internal and external) economic conditions might have played a crucial role in the success story of the early eighties—especially the easing of monetary policy. On the other hand, in 1987, wage-freezing was abolished and employees pushed the government successfully towards a serious wage increase. The suspension of wage moderation broke the positive growth trend of the economy experienced through the years of adjustment. Significant increase in real costs of labor deteriorated competitiveness and economic growth slowed down from 1988 onwards. That is, Denmark did experience a non-Keynesian fiscal episode which, however, proved to be short-lived.

4.2.3.3 The Netherlands (1993 and 1996)

The restructuring of the Holland public finances had already started in the eighties, well before the Maastricht process. By 1997, public spending had decreased by one-third from the peak reached in 1983 (in GDP). The wide-scale reforms of the mid-eighties encompassed the following elements: mutually strengthening measures in fiscal policy and incomes

policy (along with labor market reform) such as tax cut and the reduction of the real value of minimum wage. Social transfers were cut back significantly too: welfare transfers (especially sickness and disability benefits) were vigorously reduced and restructured. Public sector salaries were cut back and the links between the wages of the public and the private sector were also severed.

Table 4.8 The composition of fiscal adjustment,
The Netherlands (1993 and 1996)

	1992	1993	1994	1995	1996	1997	1992– 1997
Debt	75.9	77.2	74.4	75.2	73.3	68.1	-7.8
Balance	-4.1	-2.8	-3.4	-4.0	-1.8	-1.1	+3.0
Current revenue	49.5	50.7	47.8	45.1	45.3	44.8	-4.7
Current expenditure	50.5	50.6	48.3	46.2	44.7	43.5	-7.0
Final consumption	23.7	24.0	23.6	23.4	22.5	22.3	-1.4
Compensation of employees	10.8	10.9	10.6	10.5	10.1	10.0	-0.8
Social transfers in kind	12.2	12.4	12.3	12.1	11.6	11.6	-0.6
Subsidies	2.3	2.1	1.9	1.0	1.2	1.5	-0.8
Interest payment	6.1	6.1	5.6	5.7	5.4	5.0	-1.1
Public investment	3.1	2.9	2.9	2.9	3.0	2.8	-0.3

Source: EC (2005).

Remarks: the data cover the years of the adjustment itself (i.e. 1993–96), plus one year before and after the consolidation was initiated.

Starting in 1993, the Netherlands embarked on a drastic reduction of current expenditures: the level of current expenditure declined from 50.6 per cent (1993) to 42.3 per cent (1998). Savings on final consumption and interest payments contributed significantly to the recovery of the general budget. Interestingly, current revenues fell enormously, too: the decrease was 4.7 points of the GDP between 1992 and 1997 (data can be found in Table 4.8). The government and the trade unions worked in close cooperation with each other and were able to cut

unemployment without increasing the costs of labor. As a result, the flexibility of the Dutch labor market increased significantly, and the demand for labor rose, too.¹⁷ The improvement in competitiveness produced a robust growth compared to the neighboring countries (Watson et al. 1999). In sum, the Dutch success story was not a one-off event, but a result of a long process that had already started in the early eighties. The ultimate aim of the reform was not simply the reduction of deficit and debt but the restoration of competitiveness of the overall economy, thereby promoting sustainability.

4.2.3.4 The UK (1997–1998)

One of the most successful fiscal stabilizations was achieved in the UK in the nineties. Nevertheless, the British experience received attention not just because of the significant improvement in fiscal stance but also due to the remarkably high level of real growth rate and falling rate of unemployment, stabilizing at 5–6 per cent in the second half of the nineties, an outstandingly low level in comparison with other EU countries.¹⁸ As far as the fiscal position is concerned, the debt-to GDP ratio was placed on a downward course: the average ratio between 1991 and 1995 was recorded at 51.8 per cent, while the average of 1996 and 2000 was reduced by 10 percentage points. The same ratios for the deficit were 6.0 per cent versus 0.3 per cent. From 1998 onwards, the general government balance turned into a sufficit which prevailed until 2001. Meanwhile, the growth rate of the country accelerated, providing a spectacular 3.2 per cent annual average in the second half of the nineties, as opposed to 1.7 per cent in the first half of that decade. This nevertheless raises the issue of causality again, a topic discussed in section 3.2.3. already, with respect to the UK. It might be easily the case that the recovery in economic performance made it possible for the government to collect more revenues while spending less, thereby experiencing a recovery in the general balance.¹⁹

¹⁷ For a more detailed discussion, see section 4.3.3.2.

¹⁸ The IMF (1998) in fact warned the country that an overheating might have evolved in 1998 already, due to the strong performance of the economy.

¹⁹ According to the IMF (1999:4), for instance, the strong recovery of the budget was “transient in nature, and hence not grounds to relax policies. The bulk of the gains [of the accelerated economic growth] appears to be cyclical, reflecting the greater buoyancy of the economy.”

Table 4.9 The composition of fiscal adjustment, UK (1997–98)

	1996	1997	1998	1999	1996– 1999
Debt	52.2	50.5	47.4	44.9	-7.3
Balance	-4.2	-2.2	0.1	1.0	+5.2
Current revenue	37.5	38.0	39.0	39.4	+1.9
Current expenditure	39.5	38.5	37.2	36.7	-2.8
Final consumption	19.2	18.3	17.9	18.4	-0.8
Compensation of employees	10.7	10.3	9.9	9.9	-0.8
Social transfers in kind	11.2	10.9	10.8	11.0	-0.2
Subsidies	0.6	0.7	0.5	0.5	-0.1
Interest payment	2.9	3.1	3.0	2.4	-0.5
Public investment	1.7	1.3	1.4	1.3	-0.4

Source: EC (2005).

Remarks: the data cover the years of the adjustment itself (i.e. 1997–98), plus one year before and after the consolidation was initiated.

Turning to the composition of adjustment, Table 4.9 in fact reveals that both the increased revenues (possibly due to the accelerated economic growth) and the reduced expenditures contributed significantly to the recovery in fiscal position. While current expenditures exceeded current revenues by 2 percentage points (in GDP) in 1996, three years later the current revenues were well above current expenditures. The change in the trend can be traced back to several budget items: there was a general decrease in the level of all expenditure-types in the UK. Compensation per employees for instance witnessed a decline of 0.8 percentage points in GDP, which means a 7.5 per cent decrease (using 1996 the base year). Reductions in public investment and interest payment contributed significantly to the recovery of the general balance, too. The success of the corrections was mainly the result of the increased credibility of policymakers and the improved transparency of the policy-making process. Rule-based fiscal policy became the standard approach in the country. The launch of the so-called golden rule prohibited the cabinet to finance current spending from debt (see Buiter and Grafe 2004). Besides a debt-limit, expenditure-caps were also introduced in order to maintain the sustainability of public finances. In short, the success of stabilization efforts can be explained by two

sources: improved economic performance and the redesign of the institutional setup of planning and decision-making in fiscal policy.

4.2.3.5 And the others

European countries spent the nineties by attempting to meet the Maastricht convergence criteria. Hagen et al. (2001), however, argue that if there was a Maastricht effect at all in the '90s, then generally speaking, it pushed governments towards the implementation of a mostly revenue-based adjustment. The reason is trivial: tax increase could provide relatively quick and easily visible results and this was exactly what most of the nations wanted to achieve: to qualify for EMU-membership. The authors explicitly refer to the Belgian case where first a revenue-based adjustment was quickly adopted in order to meet the 3 per cent deficit criteria. Afterwards, the country switched to the other fiscal strategy, the expenditure-based adjustment. Such a switching strategy was adopted in fact by many in the EU in the nineties. See Table 4.10.

Table 4.10 Fiscal strategies in the EU in the nineties

Expenditure-based adjustment	Revenue-based adjustment	Switch strategy
Denmark	Austria	France
Finland	Belgium	Greece
Sweden	Ireland	Netherlands
UK	Portugal	Germany
		Italy
		Spain

Source: IMF (2003d).

Remarks: the grouping reflects the situation between 1990–1997, the adopted strategies on the road towards EMU. The grouping of the IMF, however, does not necessarily coincide with our findings based on the sample of EU-14 constructed in Chapter 2. Even Hagen et al. (2001) created slightly different groupings.

Horváth et al. (2006) identified several other explanatory variables that might have helped countries to abide by the rules of the Maastricht Treaty. They mention the role of creative accounting that cannot have by definition any real consequence on growth; the devaluations in 1992–93 at the time of the crisis of the European Monetary System; and the convergence of the interest rate that made the accom-

modation of the negative effects of a tight fiscal policy possible for the monetary authorities. Hagen et al. (1999) have also suggested that the nineties were special in the sense that fiscal adjustment proved to be less costly as it was assumed earlier. According to their empirical studies, the emergence of non-Keynesian effects in a couple of countries can be traced back to the fact that private agents recognized and respected the efforts of committed governments. Nevertheless, they predicted a restoration: after the start of the third phase of the EMU in 1999, they expected fiscal policy to show the usual Keynesian nature as it is the case in normal times—and in fact as our statistical analysis of Chapter 2 revealed, hardly any attempt was made after 2000 to consolidate the fiscal course, consequently, no non-Keynesian effects have been documented.

4.2.4 Summary

Before turning to our next topic, that is, the importance of the structure of the labor market and the wage bargaining system in facilitating expansionary fiscal consolidation, it is worth summarizing the main findings of section 4.2. Supply-side literature put a heavy emphasis on the need for cutting back politically sensitive items of the budget in order to restore the sustainability of public finances. Without a firm action in order to reduce the compensation of public sector employees and household transfers, no real possibility can be expected for experiencing non-Keynesian effects in times of a serious fiscal imbalance. The cutback of politically sensitive items supports crowding-in effects in the economy by inducing firms to invest more, due to an increased cost-competitiveness. Our simple statistical analysis and the qualitative scrutiny of countries also supported the view that it is generally not the size of adjustment alone, but—among others—the composition as well which really matters in debt-reduction and the causing of non-Keynesian effects. Alesina and Perotti (1995:240) give a succinct summary of the above: “There is bad news and good news in these results. The bad news is that one cannot avoid cutting transfers and government employment; quite simply, permanently favorable results typically do not follow from politically palatable policies. The good news is that major fiscal adjustments do not cause major recessions. Politicians and their advisers must stop thinking of just about everything on the expenditure side of government budgets as untouchable.”

Since the supply-side approaches did not embark on searching for a completely new theory of non-Keynesian effects, scholars have been taken up with empirical studies in the form of case studies and cross-country estimations. Our most fundamental conclusions with regard to the supply-side explanations in sections 4.1 and 4.2 have been the following: the need for political commitment and the facilitating structure of the labor market as a channel for accommodating the emergence of non-Keynesian effects. In modern democracies the basic question is therefore: how can a fiscal consolidation based on welfare spending cuts and government wage bill reduction be implemented in case of a *highly rigid labor market*, an inherent feature of developed market economies? In the following, this question will be addressed.

4.3 The supply-side channel: Non-competitive labor market structures

Labor markets are rigid in the sense that the change in taxes cannot significantly alter individual labor supply. Labor markets may indeed be very far from the competitive ideal. Accordingly, “[a]llowing for non-competitive labor markets becomes crucial if one wants to study ... the role of institutional factors in the transmission of the effects of taxation” (Alesina and Perotti 1997:936). The burden of labor taxes such as income tax or social security contributions cannot be placed entirely on employees because with the help of trade unions and the institutionalized system of wage bargaining workers are able to shift the costs of tax increase to the firms. In a unionized economy, employees will demand higher pre-tax wages in response to a permanent rise in labor taxes. Thus, the burden of tax increase may partly or entirely fall on the employer, causing a serious deterioration in competitiveness and profitability. In fact, in a unionized system of labor, the aggregate effect of tax increase on labor supply can be high enough to depart significantly from the neoclassical world of competitive economy.

Whether employees are able to transmit the burden of tax increase to the employer is a question of the structure of the labor market and wage bargaining system. Trade unions with a different degree of centralization and coverage internalize the consequences of tax increase differently. In a simplistic approach, if trade unions are large and encompassing, the demand for a wage increase will remain moderate. However, if unions are strong enough to pressurize the government to

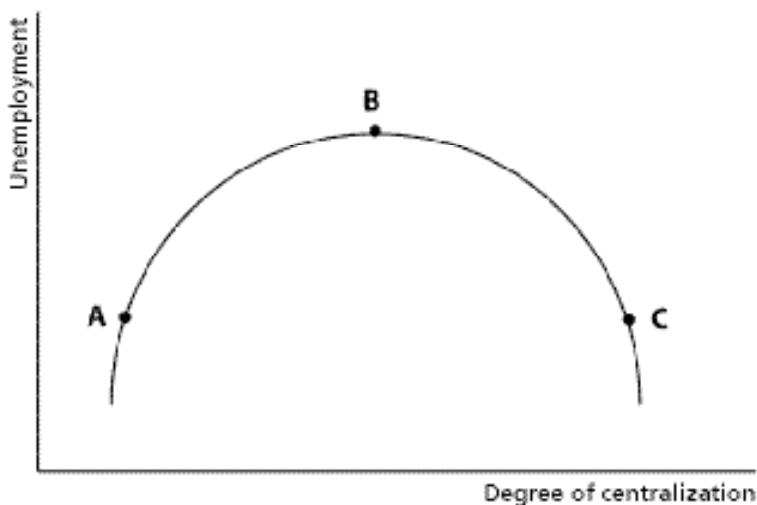
raise wages but are weak in the sense that they are unable to cover a high portion of employees, the ability for internalizing the loss of competitiveness is weak, too. Trade unions therefore will not moderate their demand for wage increase, thereby damaging the competitiveness of the country painfully. This conviction was first conceptualized by Calmfors and Driffill (1988) and it was taken as granted by many later on.

A large part of industrial relations literature tries to establish an association between macroeconomic indicators and the structure of the labor market and/or the wage bargaining system. Relying on several sources, the OECD (2004b:133) warns that making any policy decision based on such a real or alleged relationship may be misleading, since the findings of empirical research are inconclusive. Making policy choices would require a firm knowledge of the direction of causality. However, it proved to be rather difficult to draw unambiguous results. It is always problematic to measure institutional structures, (not mentioning changes), moreover institutions are embedded into a social, political, cultural context within which they must exist, and therefore the separation of the effects of institutions from the immediate environment can be doubtful. Nevertheless, the literature is highly devoted to come up with some useful characterizations of the centralization/coordination of collective bargaining and indeed it does make it possible to draw some basic guidelines.

Calmfors and Driffill (1988), instead of stating a linear and monotonic relationship between the centralization of labor market institutions (inclusive of wage bargaining) and unemployment, found an inverted U-shape relationship for instance. In the hump-shaped curve of Figure 4.3 three situations are distinguished. In case "A", trade unions are weakly organized and are not able to enforce the government to raise wages in response to tax increases. Case "B" refers to the situation where a few relatively well-organized trade unions represent the workers, however, the representation can be partial only, because these trade unions are not all-encompassing. In fact, leaders of particular organizations are responsible to their own members only. The inability of internalizing the entire costs of wage demand induces the equilibrium level of unemployment to remain relatively high. With highly centralized (and strongly encompassing) regimes, such as those in Nordic countries (case "C"), however, trade unions can negotiate with the government as unitary actors in the name of all (or most of the) employees. Since they are able to internalize the loss of competitiveness, the equilibrium rate of unemployment is relatively small, and therefore, the

wage increase remains moderate. Both decentralized and highly centralized (with wide coverage) regimes are capable of ensuring wage moderation and consequently a relatively low level of unemployment.²⁰

Figure 4.3 Trade-off between the degree of centralization of collective bargaining and the equilibrium rate of unemployment



Source: own construction after Calmfors and Driffill (1988).

The three points on Figure 4.3 corresponds to three different types of wage negotiation systems. In a highly centralized labor market with very few organizations (and with large coverage), the wage negotiation takes place on a nation- (or economy-) wide level.²¹ The sensitivity to

²⁰ Although the best-known source for recognizing the hump-shaped relationship is Calmfors and Driffill (1988), Dahl (1982) came also to the same conclusion in a comparative political study. Dahl tried to explain and propagate the diversity of pluralist democracies, claiming that concrete political institutions make democracy highly divergent in different countries. One of the most important elements of such a diversity is the organizations of employees and employers, he argued.

²¹ Agreements can be extended to everybody not just in the presence of an all-encompassing and centralized trade union but also if the state applies the collective agreements to everyone or employers extend the wage agreement to non-unionized workers. Labor market institutions can be changed, improved, etc. by the inducement of employers and the state as well, therefore trade unions are not the single determinants of wage negotiations.

budget constraint (that is, the ability to internalize the interrelationship between higher taxes and redistributed welfare spending) is high enough to moderate wage demand. Moreover, in countries such as Sweden, Norway, Denmark, Finland or Austria, social partners are highly concerned with other macroeconomic consequences of tax increase such as the rate of inflation or economic growth. Point B, on the other hand, refers to industry level negotiations where the powerful minority extract the benefits of wage negotiations without being sensitive to the social costs of their wage demand. Point A is the closest one to the neoclassical world of competitive markets, where atomistic agents cannot pressurize the government to increase wages. Countries such as the USA, Canada, Japan, Switzerland, Australia or the UK belong to the group of firm-level negotiations.

However, centralization is probably not the best (or not exclusively the best) indicator of labor market institutionalization. In Soskice (1990), *coordination* plays the role of the independent variable. Several examples in the EU justify his point, as we will see later in section 4.3.3. The presence of social pacts or pattern bargaining can significantly alter the outcome of wage negotiations even in a relatively deregulated labor market (Table 4.11 shows the need for differentiating between the two measures).

Three lessons can be drawn from Table 4.11: (1) the level of centralization did not change anywhere in the countries under scrutiny during the nineties, while there were several moves in the chosen type of coordination mechanism; (2) a great variance can be experienced within a given type of coordination regarding centralization (especially in the group of state-sponsored coordination), that is, the association between centralization and coordination can be rather weak; and (3) the successful fiscal consolidation in EMU countries was initiated mainly in the group of state-sponsored coordination, a fact that redirects attention to the significance of *social pacts* (see below).

Accordingly, the remark made by Soskice (1990) should not be interpreted only as a methodological, but also as a substantive one in the sense that the nineties witnessed the restructuring of European industrial relations, where albeit the degree of centralization might not have increased (in fact, it decreased), but the level of coordination and the method of bargaining changed dramatically. It is not the power of trade unions that has been strengthened, but the capacity of social partners to get a say in influencing incomes policy, and sometimes other segments of economic policy, too.

Table 4.11 Wage coordination in euro-zone countries on the road to EMU

Type of wage regulation	1991–1993	1997–1998
State-sponsored coordination	B (3), FL (5), IT (2), IR(4), NL (3), P(4)	FL (5), IT (2), IR(4), NL (3)
Intra-associational coordination	ES (3)	ES (3), P (4)
Pattern bargaining	A (3), G (3)	A (3), G (3)
State-imposed coordination	F (2)	B (3), F (2)

Source: Traxler (2002); OECD (2004b), own additions.

Remarks: degree of centralization in parenthesis (source OECD). The data for centralization are for 1990–94 in the first column and for 1995–2000 in the second column.

4.3.1 The changing characteristics of the European labor market and wage bargaining system in the Maastricht process—the revival of social pacts

The EMU membership created a considerably different situation for countries regarding macroeconomic policy coordination (see Table 4.12). The practice of economic policy has been unequivocally divided into three: monetary policy, fiscal policy and incomes policy. Usually, it is the monetary and the fiscal policy which are said to have experienced dramatic changes with the launch of the single currency project. However, the new set-up reevaluated the roles of the labor market and incomes policy significantly, too. Monetary policy is out of the hand of the member states; the ECB's primary concern is price stability. Fiscal policy is still in the authority of national governments but first the Maastricht Treaty and later the Stability and Growth Pact greatly limited the scope of stabilization policy. In turn, labor market adjustment and wage flexibility have remained the only devices in tackling exogenous shocks, thereby attaching a greater than ever significance to the supply side. Allsopp and Artis (2003) argue indeed for a consensus view which involves the appropriate reaction function of the ECB, the fiscal rules limiting deficit financing in member states and wage (or supply side) flexibility.

In accordance with the changed perspectives in macroeconomic policy-making, the nineties in Europe experienced significant changes in labor markets and wage negotiations. On the one hand, the Maastricht process strengthened the flexibilization of labor markets—as it was

Table 4.12 The level and time horizon of economic policy in EMU

	National level	Supranational level
Short term	• active fiscal policy • incomes policy	• active monetary policy
Long term	• labor market restructuring and wage flexibility	• passive monetary policy • possible concertation among European social partners

Source: own construction.

suggested by Allsopp and Artis (2003) and their so-called “consensus view”. However, this happened within a *more coordinated* structure of collective bargaining on the other hand. According to the OECD (2004b:130), when comparing the seventies and the nineties, no OECD country attempted to initiate a greater degree of centralization in collective contracts negotiations, while some countries did move towards greater decentralization. Nevertheless, this move was supplemented by a strengthened coordination that could take place in the forms of social pacts, pattern bargaining, peak-level coordination or stronger government involvement in tripartite negotiations.

Soskice (1990) and Hancké and Soskice (2003) argued that albeit centralization might not have been improved in the last few decades, *coordination* has strengthened (recall Table 4.11). The structural changes in the world economy have strongly motivated EU countries to make further adjustments in the labor market and the wage bargaining system. The ultimate aim was to create a system of collective bargaining which could ensure the maintenance of competitiveness. In most cases, the means to this end was found in the formally or informally adopted *social pacts*—a definition of which may be the following: “specific forms of macro-cooperation in relation to other related forms of macro-concertation or political exchange, [which] generally arise between representatives of government and organized interests who negotiate and coordinate policies across a number of formally independent, but actually related and interconnected policy areas (incomes, labor market, fiscal, and social policies) and levels (national, sectoral, regional, local)” (Avdagic et al. 2005:6).

In general, social pacts reflected the recognition that both employers and employees could mutually benefit from an agreement which pushed labor markets in the direction of more flexibility but kept wage negotiations in a highly coordinated framework, which enabled the

partners to strike an agreement on wage accords.²² Practically, the revival of social pacts meant that decisions on wages were transferred into the hands of a few centrally appointed experts—although not necessarily in a formal and binding way. Hancké and Soskice (2003:152) summarize this complex development succinctly:

The main reason for the continued strength of coordinated bargaining is that it has been in the interests of employers, governments, and unions to maintain it... Given that unions use the system to ensure that wages are internationally competitive, it enables employers to avoid the wage-spiral effects... In addition, employers and unions have understood the growing restraints through the 1990s on using devaluation as a means of restoring competitiveness. And for governments (...) the need to meet the Maastricht conditions meant that coordinated bargaining was a valuable instrument in the development of social pacts...

The late eighties and the nineties witnessed a proliferation of social pacts in Europe but it does not mean necessarily that they were alike. In fact, just the opposite is the case. In a few instances they were reinvented, in the sense that social agreements among social partners and the government had a long history, such as in Italy and especially in the Scandinavian countries. In other countries, such as in Ireland for instance, no such history existed; in fact, macro-concertation was not known previously. The conditions and the institutional-legal settings which characterized the neocorporatist structures of quite a few developed European nations were entirely missing in Ireland or Portugal initially.²³

²² A typical remark from the literature of industrial relations: “[i]nstitutions and procedures of social partnership thus remain central to the political economies of most west European countries. At the same time, policy outcomes, driven in neoliberal directions by European and global markets, nonetheless continue to incorporate strong labor and social standards. *Free market economics, ... far from dismantling social partnership in western Europe, is paradoxically driving (and has been tempered by) social pacts, dialogue and partnership negotiations.*” Iankova and Turner (2004:81). Emphasis added.

²³ In the Ireland of the early (or even the mid-) eighties, no one believed that social partners could agree with the government on a wide-scale reform program, that was supported by a social pact. The newspapers for instance did not mention the possibility of such an agreement since the Irish labor market was just like the British: a highly decentralized one where social partners were not invited to take part in economic policy making during those years.

More interestingly, the motivation for the (re)invention of social pacts from the late eighties was fundamentally different from that of the sixties and the seventies. Earlier, it was the redistribution of national income what motivated agreements between social partners and the government. The eighties and nineties, however, drastically changed the aim and character of social agreements: preserving jobs by strengthened cooperation in production. Practically it meant that the partners were ready to agree on the need for raising the competitiveness and profitability of certain sectors and companies by moderating demand for a wage increase. While social agreements previously aimed at ensuring the extension of the social security system along with specific welfare measures, the new wave of social pacts tried to reform the welfare state itself, quite often by restricting the range of and the access to certain entitlements. In fact, the context within which the social pacts of the late eighties and the nineties evolved (i.e. the intensified global competitiveness, the emergence of the European internal market and the Maastricht process) dramatically redefined the role and the content of social pacts. It gave more power to the center (and the government), while it also strengthened lower-level negotiations. However, meanwhile, the fundamental objective was to re-regulate the formal relationships, defend the competitive edge of the economy and emphasize the support of economic growth (wealth creation) instead of the redistribution of growth.²⁴

Accordingly, as opposed to the early years of corporatism, the resurgence of social partnership was not accompanied by the revival of trade unions. Wage moderation did not come along with providing extra benefits for employees—as it was the practice in the sixties and seventies. Social pacts simply did not mean the strengthening of trade unionism in Europe. Checchi and Lucifora (2002) provide a convenient framework to interpret the role of trade unions. The authors argue that beyond the traditional wage bargaining role, unions are the providers of insurance for labor market risks. Labor market risk have become less relevant in the last decades in the EU, however,—because of the universal insurance offered by the state via different institutions such as job security legislation—consequently there is a lesser need for

²⁴ On such a shift, see Regini (2000), Rhodes (2001) and Traxler (1995).

union protectionism.²⁵ Accordingly, from a policy viewpoint, “the future role of unions is likely to depend very much on the design of policy mix concerning deregulation, privatization and reduced welfare provisions that are currently in the policy agenda of European countries” (ibid. 400). European countries found social pacts the proper solution in designing that policy mix—without reinforcing trade unionism.

The new social partnership, however, did not aim at eliminating lower level negotiations at the expense of strengthened top-level agreements. (The coexistence of the past structures and the newly designed system of coordination has ended up quite often in a multi-tier collective bargaining regime in the EU countries, see Table 4.13). Social pacts instead provided a solid framework with specific rules and procedures with the clear aim of attaining economy-wide goals—a process often referred to as *concertation* in the industrial relations literature. Such an “organized decentralization” (a term invented by Traxler 1995) appeared in fact in most of the EU member states, including Italy, Portugal, Ireland, the Netherlands, Finland, Greece, Belgium, Austria and Spain. Interestingly enough, in Chapter 2, our statistical analysis revealed that these were mostly the countries where expansionary fiscal consolidation was observed at some time. The Dutch for instance initiated such pacts as early as 1982. Ireland institutionalized social partnership in 1987 and the country still heavily relies on the system of tripartite agreements.

Others, however, followed different directions. France did not join the new trend of revitalizing social pacts. More interestingly, the German-type industry-level negotiation system, which strongly influenced wage negotiations in some other countries earlier, was expected to become the ideal type of negotiation across Europe. However, such a convergence did not evolve in Europe in the nineties (Regini 2000). Probably, it is no accident that these two countries are indeed not counted as ones

²⁵ These policies can indeed crowd out unions. One response from unions to the increased crowding out (and the decline in union membership) was to form multi-sector super-unions in order to mobilize resources more efficiently, to utilize economies of scale. The last decades have witnessed large-scale mergers, especially in the UK and Ireland (where the three largest unions together still account for less than half of the total membership of the confederations), but also in Germany and the Netherlands (assembling more than 80% of the total membership), in Italy and to some extent in the Nordic countries as well (Ebbinghaus 2004).

Table 4.13 Multi-tier collective bargaining in the EU

	National level	Sectoral level	Enterprise level
Austria		+++	
Belgium	++	+	+
Denmark	+	++	+
Finland	+	++	+
France		+	+++
Germany	+	+++	+
Greece	+	++	+
Ireland	+++	+	+
Italy	+	+++	+
Luxembourg		++	++
Netherlands	+	+++	+
Portugal	+	+++	+
Spain	+	+++	+
Sweden		+++	+
UK		+	+++

Source: Grahl and Teague (2003:398).

Remarks: + evident, ++ important, +++ dominant.

which were able to conduct a major adjustment which would have resulted in expansionary effects. It seems reasonable to claim therefore that a social pact may support the emergence of expansionary effects in times of fiscal consolidation. A pact can strengthen the credibility of the agreement on wage moderation and other contractionary fiscal measures, thereby inducing both supply-side and demand-side responses from private agents. The experience of Ireland and the Netherlands pinpoints to the usefulness of social pacts in achieving fiscal adjustment, without serious deterioration in economic activity. Apparently, the only exception seems to be the UK, where the deregulated labor market (without a social pact) might have contributed to the expansionary effects.

4.3.2 Country studies

It was argued in section 4.2 that political decisiveness is crucial for the success of fiscal adjustment. By reviewing the literature and conducting our own data analysis, it has been demonstrated that without the political willingness of policy-makers to cut back politically sensitive items of the general government, the ultimate effects of the stabilization effort can be counterproductive. European experiences support the

view that political willingness in turn, however, depends largely on a strengthened social partnership which can legitimize governmental efforts. The explicit trend of reviving social partnership in the way towards EMU, however, does not mean that cross-national differences did not prevail in Europe. Next, three case studies will reveal how non-Keynesian effects were backed by either a more coordinated but less centralized labor market structure (in Ireland and the Netherlands) or further deregulation of the labor market (in the UK).

4.3.2.1 Ireland

By launching the Programme for National Recovery (1987–90), the government won the explicit support of social partners to its fiscal adjustment program, concentrating mostly on spending cuts. By doing so, the tripartite agreement of 1987 in Ireland could strongly support the emergence of the expansionary effects of fiscal consolidation. The government could put a stop on wage increase both in the private and the public sector with the consent of the unions and employers.²⁶ The government in return accepted that the tax burden on labor (a legacy of past attempts of failed fiscal adjustments) would also be reduced. The labor market was highly flexible already before the consolidation and remained strongly liberalized in the nineties, too. The system of wage coordination was restructured, however, significantly: a two-way trend had evolved. From the late eighties onwards, wage bargaining was concentrated to a great degree, but the ultimate bargaining was carried out still in firms (keeping in mind the binding central regulations which maximized the size of wage increase).²⁷

²⁶ Wage share in the business sector fell sharply and the growth rate of the real wage per efficiency remained moderate (OECD 2004b:137).

²⁷ A remarkable feature of the Irish wage moderation is its consistency and persistency. While Ireland produced the highest growth rate in the EU—which stemmed significantly from productivity improvement—employees refrained even in the most recent years from harvesting all the fruits of the advantageous economic performance. To say it in numbers: while productivity increased by 4.7 per cent on an average between 1999 and 2003, the net (real) pay increase remained relatively moderate at 1.2 per cent. Such an extensive moderation could also be achieved only in Finland, where the difference between productivity gain and net pay increase was 2.3 per annum. What is common in the two countries is the level of wage negotiations: a mix of nation-wide and sector-level negotiations. (For a more detailed discussion, see Ebbinghaus 2004.)

The huge success of the corrections in the late eighties, which were comprised of both demand-side and supply-side elements, gave rise to an ever-closer cooperation of social partners throughout the nineties, too. The National Council, following the fiscal consolidation, agreed upon a general and comprehensive reform of the welfare state in 1990. ERM membership and the possibility of joining the EMU extended the cooperation to areas which mainly involved supply-side measures such as training, education, employment or investment in information technology.²⁸ From the very beginning of the revival of social pacts, there was an interest in widening the range of partners involved in social partnerships. Groups such as the unemployed or women could also express their views on various social and economic issues (O'Donnell and O'Reardon 2000). Nevertheless, it is difficult to set down a causal relationship between the revival and strengthening of social partnership and economic growth in Ireland. For sure, supply-side measures contributed in large to the astonishing growth rate, which was not only significantly above EU average during the nineties but also reached a remarkable level of 10 per cent in 1997. Social pacts definitely contributed to the success, however, the high growth rate made it also easier to reach agreements between partners.

4.3.2.2 The Netherlands

Unemployment decreased significantly in the nineties in the Netherlands (to 4 per cent in 1998), producing one of the lowest levels in the EU. The reduction was the result of a complex set of measures. Most importantly, the labor market liberalization was speeded up by introducing the system of part-time work, supplemented with a general reduction in working hours. Early retirement was also a component of the new initiatives. Job generation and wage moderation both con-

²⁸ The nineties witnessed the birth of three additional social pacts, namely the Program for Economic and Social recovery (1991–93), the Program for Competitiveness and Work (1994–96) and finally the Partnership 2000 (1997–2000). Each pact defined characteristically different aims to be achieved, reflecting largely the challenges the economy faced at that time. (Based on the categorization of Avdagic et al. 2005, the Irish social partnership belongs to the group of headline social pacts, since it had been weakly integrated but a wide range of issues had been covered.)

tributed to the revitalization of the Netherlands (Wolinetz 2001). These fundamental changes of the labor market might not have been achieved without the Wassenaar Accord, which had been set up in 1982 after many years of tough negotiations. The earlier practice of centralized wage negotiation had been suspended and the country moved towards a decentralized regime of bipartite agreements. Nevertheless, it was the Maastricht process which gave the final impetus to the consolidation of the new labor regime. From 1992 onwards, several social pacts had been adopted in the country with the explicit aim of making the changeover to the euro a swift process and to ensure the competitiveness of the Dutch economy. In 1993, a tripartite agreement institutionalized a system of decentralized wage bargaining with strong top-level coordination: only the framework was provided by the top negotiators, the final details were left to the works councils. One of the most striking features of the new deal between social partners was the support of tailor-made contracts. The aim of the new approach was to cover the common interests of workers and employers; wage moderation ensured that profitability and competitiveness were not threatened.

Nevertheless, the Dutch model was not without difficulties either. The government tried to enforce even more intensive top-level coordinated wage negotiations combined with the reform of the welfare state, however, neither the unions, which supported an industry-level agreement, nor the employers, who backed the company-level bargaining, proved to be partners in this attempt (Regini 2000). Therefore, the issue of the retrenchment of the welfare state was carried through against the firm opposition of the unions in the nineties. It clearly transpires that the success of the Dutch model strongly depended on the willingness and flexibility of the partners, since the social pact was built fundamentally on guidelines only. Nevertheless, it is probably not an exaggeration to claim that the impressive performance of the Dutch economy during the nineties was also due to the supply-side adjustment rather than just pure fiscal cuts.

4.3.2.3 *The UK*

Evidently, the odd-one-out in the sample of the countries is the UK, where no social pacts have been adopted in the last few decades. Nevertheless, it is worth elaborating on the British labor market structure and wage negotiation system, since the UK implemented a successful

expansionary fiscal consolidation in the second half of the nineties. Accordingly, it may be easily the case that apart from social pacts, a strongly deregulated labor market, where individual shop floor negotiations prevail, can also effectively support the emergence of non-Keynesian effects.

The UK has had the most deregulated labor market in the EU since the early eighties, one that had been supplemented with a decentralized wage bargaining system and with no effective coordination in place. The crushing of union power was initiated by legislative actions from the late seventies onwards. Union recognition procedures for instance were suspended in the eighties (a major force behind the decline in density and coverage ratios) and have been reintroduced only in 1999 under the Employment Relations Act—however, the recognition is made upon request only.²⁹ Nevertheless, authors such as Barnard et al. (2003) warn that the relatively high degree of deregulation was achieved even in spite of the declared wish of Brussels. An expressive example is the British derogation in the Working Time Directive of 1993. Employees are allowed to opt out of the 48-hour limit by individual agreements with the employer.³⁰

British unionism, in fact, always heavily relied on voluntary principle. In the UK, the institutional settings and the norms were simply missing in the nineties (and even today) to pursue a wide social dialog and to maintain wage moderation. Organizations are decentralized just like the wage agreements which are delegated to firms. In the case of the UK, there was no history or background on which the country could have built a revival of social partnership (in this sense the sectoral unions of the sixties and seventies were highly exclusive and their wage pressure caused serious deterioration in main economic aggregates). In finding the adequate answers posed by globalization and intensified world-wide competition, the UK has gone ahead with fur-

²⁹ Although the restoration of the trade union recognition was put in force in June 2000 only, its possibility had been raised as early as 1995, when the Labor takeover of the government had first emerged as a real possibility (Gall 2004).

³⁰ 16 per cent of the labor force work more than 48 hours a week in the UK. The opt-out is almost at 100 per cent in the hospitality sector, but financial sector corporations and international law companies use the derogation extensively, too (Barnard et al. 2003:463).

ther deregulation in labor market. Although the UK applied a definitely different approach in restructuring its labor market than the other countries reviewed above, the British way of deregulation was almost as successful as the Dutch social pact approach in reducing equilibrium level employment via supply-side measures (Nickell and van Ours 2000), providing another viable route for countries who wish to live up to the challenges of globalization and intensified competition.

4.4 Summary

Chapter 3 has not provided satisfactory answers to the question of why non-Keynesian effects may occur at certain times and in certain countries. While the discussed consumption channel was theoretically appealing, it has not received a convincing level of empirical support in the literature. In Chapter 4, therefore, we left behind demand-side approaches and have turned to the supply side. By surveying the international literature and conducting some descriptive data analyses, it has been shown that the composition of fiscal consolidation can have a significant effect on determining whether the adjustment proves to be expansionary or contractionary in the short term. We have argued that expenditure-based fiscal stabilizations have a significantly higher chance of ending up in reduced-cost adjustment (or even in non-Keynesian effects) than revenue-based adjustments. Moreover, it has been revealed that basically two budget elements need to be cut back if the government aims at producing growth effects already in the short term: compensation of public sector employees and household transfers. Nevertheless, these items are considered to be the politically most sensitive items of the budget; the constitutive parts of any welfare state. Therefore, the cutback of these politically sensitive items may call for political decisiveness which in turn can be backed up by a strengthened social partnership, as it was the case in several European countries.

The close scrutiny of the labor market structure and wage bargaining mechanism of the most successful European countries—as the main channel of the emergence of non-Keynesian effects—placed the import of social pacts at the very heart of our analysis. The Maastricht process strengthened the flexibilization of labor markets in Europe considerably, however, this happened within a more coordinated structure of collective bargaining. Social agreements received a distinctly new character from the late eighties onwards. These redesigned agree-

ments did not wish to widen and further burden the social security system along with providing more welfare measures. Instead, the revival of social pacts aimed at reforming the welfare state itself, quite often by restricting the range of and the access to certain entitlements. The competitiveness of companies and the security of jobs were believed to be maintained only by the full internalization of the wage demand costs. Consent in some countries to reform welfare provisions made it possible to embark on wide-scale stabilization programs by cutting back the politically sensitive budget items along with other measures to reform the labor market itself, as it was documented especially in the Netherlands and Ireland. The UK was also able to implement cuttings on the spending side, although it did not try to revive the system of social agreements (if something then just the opposite is true). Here, the deregulated labor market provided the ground for initiating stabilization efforts.

Based on our previous analyses, the lessons are manifold for any country that needs to embark on a fiscal consolidation and hopes to reduce the costs of adjustment as much as possible, or to experience expansionary effects in order to ensure the irreversibility of reforms:

- (i) Reducing the deficit may not guarantee a lasting and growth-supporting consolidation. It is not the size *per se* what matters but the quality, i.e. the composition of adjustment, in the success of adjustment.
- (ii) While the credibility and the wealth effect may contribute significantly to the increase of private consumption, thereby boosting economic growth in the short term already, supply-side mechanisms may have a larger role in triggering expansionary effects in case of fiscal consolidation. Increased competitiveness of firms may induce a higher rate of private investment.
- (iii) While governments would find it necessarily difficult to cut back politically sensitive budget items, a social consensus in the form of a social pact can make it easier to embark on the much-needed efforts. Importantly, social pacts do not aim at bringing back the neocorporatist past of the sixties and seventies. Instead, they try to reinforce competitiveness and secure jobs by moderating the demand for wage increase. While previously social agreements attempted to ensure the extension of

the social security system along with specific welfare measures, the new wave of social pacts tried to reform the welfare state itself.

- (iv) If there is a lack of structure which supports the establishment of social pacts, a deregulated labor market can also facilitate the successful implementation of fiscal consolidation as it happened in the UK, although in this case the government has to be determined and must gain credibility as soon as possible, otherwise market agents would not believe in the commitment of the cabinet and the stabilization process may easily fall into reverse and be further delayed.

Chapters 3 and 4 explored the concept of non-Keynesian effects. The chapters provided different rationalizations of the same phenomenon: expansionary effects in times of fiscal consolidation in the short run—a basically counterintuitive experience first documented in Ireland and Denmark in the eighties, but followed by several other episodes throughout the nineties. Surely it would be an exaggeration to state that we have found and verified a casual relationship between fiscal adjustment and growth acceleration. Nevertheless, by a detailed analysis it has become possible to highlight those mechanisms through which and those conditions on which expansionary effects may emerge.

Moreover, the two approaches of non-Keynesian effects (i.e. demand-side and supply-side interpretations) are naturally not mutually exclusive. In full agreement with Rzonca and Cizkowicz (2005:9), it is claimed instead that “the different views are not competing, but complementary.” In order to implement a successful fiscal adjustment—one which restores fiscal balance and puts the economy back on a sustainable track with the least possible costs—governments should be sensitive to a complex set of measures which exert effects through both the demand-side and the supply side, thereby mutually strengthening each other’s effect. Admittedly, such a “package” is more complex than what we have managed to show here.

CHAPTER 5

Financial Intermediation in Hungary

A Comparative Perspective

Although understanding the mechanisms and identifying the main triggering and facilitating factors which contribute to the possible emergence of non-Keynesian effects is a serious challenge in itself, the book wishes to take a wider perspective and—applying the framework that has been worked out in Part One—will test the relevance of the identified institutional conditions in a particular country. The critical assessment of the theories on non-Keynesian effects and the generalizations drawn from the statistical analyses of the old member states of the EU provide the opportunity to raise the following question: is there a chance for Hungary, a country waiting for euro-zone membership, to embark on a fiscal consolidation without facing necessarily the short term trade-off between adjustment and economic growth?

Why Hungary? The reason for the selection is clear: this is the country in the EU with the largest deficit at present (estimated at 10.1 per cent of the GDP in 2006), making Hungary one of the most vulnerable economies in the region. The delay in fiscal adjustment can cause a serious deterioration in the potential rate of growth and can dramatically erode the prospects for sustainable economic development.

However, the incredibly high level of deficit (and debt) is not an absolutely new phenomenon in Hungary. It was characteristic of both the pre and the post transformation periods of the country. It is worth recalling that Hungary was always well-known within the communist bloc for its readiness to guarantee a relatively high standard of living for the people. Party leaders of the previous regime wished to stabilize their political power by providing economic growth and prosperity. They intended to buy *the loyalty of the citizens* towards the socialist regime itself. The 1956 revolution made the leaders cautious and sensitive to the wish of the wider public. The terms “goulash communism”

or “the happiest barrack” refer exactly to this delicate balance. During the oil shocks of the 70s, the Party was therefore highly reluctant to tighten public spending and to undertake a fundamental restructuring of the economy. Since domestic capacities were fully depleted, over-spending was financed mostly from abroad, which resulted in an increasing foreign indebtedness.

Interestingly enough, even after the political change of Spring 1990, the first freely elected (conservative) government did not deny consumption-orientation; in fact, such a strategy remained an imminent feature of the democratic Hungarian political regime (Kornai 1997). In times of the transformational recession, when Hungary suffered an 18 per cent decrease of its GDP, politicians seemed to be unwilling to reduce the wide-scale provisions of the pre-born welfare state, causing serious (further) deterioration in public finances. While Hungary achieved significant results in the field of microeconomic restructuring, the macro perspectives of the country deteriorated day by day.¹

The Mexican financial crisis of 1994–95, however, made it overt for Hungarian policy-makers that the stabilization of the macro economy was unavoidable. The new socialist-liberal government adopted a severe austerity package in March 1995. The fundamental goal of the surprise measures were to remedy the disequilibria in both the foreign and the internal balances, thereby stopping the dangerous spiral of indebtedness, and consequently to regain the trust of foreign investors. Evidently, the package was a clear admission of the failed macroeconomic practices of earlier years.²

¹ The taxi and lorry drivers’ opposition against the price increase of petrol paralyzed the decision-makers as early as September/October 1990 and made the cabinet reluctant to embark on further restrictive policies. Accordingly, Antal (1998) described the following years (especially the period of 1992 and 1994) as a time of inaction, when discretionary measures were adopted in order to block the negative consequences of the fall in the GDP.

² The most important elements of the package were the following: a drastic one-time devaluation of the Hungarian forint (by 9 per cent), the shift to a new exchange rate regime (the so-called crawling peg system), the introduction of the convertibility of the Hungarian currency, the adoption of an extra import surcharge (8 per cent), a wage freezing in the public sector, the abolishment of various welfare spendings, and the speeding up of the privatization process.

Although the economic activity slowed down in both 1995 and 1996, in the following year, in 1997, the country started to show an accelerated economic growth, relying basically on the boom of the *export sector*. Based on the strong growth rate of the economy (above 4 per cent on average), along with sharp improvements in competitiveness between 1997 and 2000, analysts predicted a steady catch up by which Hungary could have been able to reach the EU-average within 30–40 years (OECD 2004a). The business-friendly structural policies, along with accelerated privatization and the consolidated and prudent banking sector, contributed significantly to the optimistic predictions. By the application of the comprehensive policies, the initial problem of external indebtedness was reduced substantially; moreover, and more importantly, the stop-and-go, improvised style economic policy was left behind for good, thereby earning the admiration of international financial markets (Antal 2000).

Although the so-called Bokros-package—named after the finance minister who initiated it—provided ample room for politicians to engage in further reforms of the public sector, Hungary did not use this opportunity. Furthermore, following the relatively successful period of 1996–2000, a new era has emerged from the late 2000 onwards. Antal, Csillag and Mihályi (2005) define this period as the time of neo-Kadarism, a term that reflects the rebirth of consumption-orientation. The expression highlights the return of an expansionist state paternalism, financed by increased deficit and debt; and it refers to the unwillingness of politicians to embark on the radical and necessary policy changes especially in the field of public finances.

The post-2000 years have been heavily burdened with fiscal profligacy, irrespective of the political makeup of the governing coalitions.³ Hungary—due to the lack of action and ill-conceived policy choices—has found itself in the crossfire of swelling criticism: international rating agencies have downgraded the country, and even Brussels has blamed Hungary several times, thereby making the loss of credibility of the Hungarian economic policy (and policy makers) fully overt. In fact, in two consecutive years (in 2004 and 2005), the Council decided

³ In 1998, a conservative cabinet, headed by Viktor Orbán, came into power, which was followed by the alliance of the socialists and the liberals in 2002—who also won the last elections in 2006.

to refute the Hungarian convergence program because of its unreliable data and the unrealistic development prospects. It is not surprising therefore that the alternating governments have already missed the euro-zone entry date several times.

The years of the new millennium can be best characterized as a permanent election campaign where both the incumbents and the opposition tried to outperform their rivals by promising more spending from the budget without keeping an eye on the financing constraint of their populist measures. In such an environment no real breakthrough can be expected, unless the governing forces admit that without a firm set of corrective measures international financial markets will put a stop on Hungarian indebtedness, triggering crisis-induced stabilization that will come across with substantially larger costs than in the case of a government-induced consolidation. A credible consolidation package should not necessarily end up in a deceleration of economic growth in the short term—as it has been shown in Part One. However, certain conditions must apply. Accordingly, based on our previous analysis, three aspects of the Hungarian economy will be scrutinized in Part Two:

- (i) the depth of financial intermediation—assuming a positive correlation between the former and the lack of liquidity constraints, thereby increasing private consumption in times of a credible fiscal adjustment (Chapter 5);
- (ii) the composition of the general budget, focusing especially on the spending side of the budget, since cutting back certain spending items can trigger a boost in private investment already in the short term (Chapter 6);
- (iii) the structure of the labor market and the wage setting mechanism which may facilitate the emergence of non-Keynesian effects if either a social pact is adopted or a further deregulation is achieved (Chapter 7).

In the forthcoming chapters, however, not only the most recent developments of the Hungarian economy—or more precisely the above three parts—will be reflected upon; instead a wider perspective has been applied in order to put the latest tendencies into a historical perspective.

5.1 An introduction to the study of financial intermediation in Hungary

The financial system has had an undisputable importance in the transformation and development process of Central and Eastern Europe. Generally speaking, the financial system plays the ultimate determining role in resource allocation by providing the appropriate channeling mechanisms, collecting savings and allocating these into investment opportunities, thereby promoting economic efficiency. As such, financial institutions play an indispensable part of market economies. The level of development of financial intermediation reflects the maturity of the economy itself since financial institutions are the ultimate means for remedying market failures stemming from asymmetric information such as moral hazard or adverse selection. Starting with the eighties, endogenous growth theory tried to accommodate the functions of financial intermediation into their models, theoretically proving the positive relation between financial markets and economic development. It has been shown that without these institutional remedies economic growth would decelerate below the potential rate (see especially Levine 1997). Bearing in mind the direct and indirect positive effects of financial intermediation, it is hardly surprising that in countries which have just left behind transformation and joined the EU, financial institutions have a substantial role in overcoming the shortcomings of the market economy by eliminating market frictions, reducing transaction costs and providing risk-sharing via asset transformation and asset diversification and moreover by facilitating a stable economic growth.

Accordingly, in this part of the volume a review of the development of the financial system—or more precisely that of the financial intermediation—will follow. In Chapter 3 it has been shown that the level of penetration of financial intermediation may have a substantial effect on the intertemporal decisions of households facing credit constraint. It has been argued accordingly—on the basis of the expectational view of fiscal policy—that the emergence of non-Keynesian effects on the demand side may be largely supported in an environment of developed financial markets; and moreover, the deregulation and liberalization of financial markets can substantially reduce the share of households which suffer from a liquidity constraint. Therefore, the aim of this chapter is to analyze the depth of financial intermediation in Hungary. Following a short introduction (section 5.2), which elaborates on the

legacy of a planned economic system, the stylized facts of the region will be reflected upon in section 5.3. Section 5.4 puts the Hungarian banking sector into a comparative perspective, while sections 5.5 and 5.6 concentrate on Hungary's banking industry and housing market exclusively. Before the conclusion, section 5.7 highlights the Hungarian financial market's main sources of vulnerability.

5.2 Transformation and the legacy of the past

The establishment and consolidation of money and capital markets took a long and painful period of time and required enormous efforts and investments in Central and Eastern Europe. As a result, the financial sector has undergone substantial restructuring in the last fifteen to twenty years. In fact, banks existed under the communist rule as well. However, the banking sector was comprised of a small number of specialized banks which provided services for a given segment of the economy exclusively—such as foreign trade or collecting household savings. The tasks of the central bank were also different from Western norms: they served the interest of the government/party. Accordingly, the role of banks was to finance the planned production, determined centrally by state agencies.

In fact, just less than two decades ago, there were no real banks or capital markets in the region. That is, countries had to re-invent the financial industry. The lack of financial intermediation proved to be a serious bottle-neck after the change when the new private-owned companies were formed and entrepreneurial activity grew spontaneously. Consequently, among the most important goals of the new democratic regimes was the establishment of a functioning and stable financial intermediation system without which no successful transformation could have been carried out.⁴

As a corollary, establishing a stable market economy required several complex institutional reforms in the field of the financial system during the years of transformation. The most important steps were the following:

⁴ Hungary, however, was an exception in the sense that the two-tier banking system was introduced as early as 1988 in the country, well before the regime change. Nevertheless, Várhegyi (2002) commented critically that commercial banks were created before the change already to make the previous regime work smoothly, that is, the new institutions could not function as real intermediaries.

- (i) implementing a shift towards a two-tier banking system, separating commercial activities from central banking;
- (ii) eliminating sectoral restrictions on the specialized (functional) banks;
- (iii) restructuring the ownership structure of the banking system mainly via privatization and green field investments;
- (iv) providing access to foreign banks and joint ventures in the CEE financial markets;
- (v) liberalizing the services of the banking industry;
- (vi) establishing and consolidating the legal, regulatory and supervisory framework.

The experience of developed market economies shows that balanced and sound economic development cannot be achieved without a stable financial system. Attaining financial stability, however, proved to be a serious challenge with significant costs for CEE countries in the years of transformation. One of the bitter experiences of transformation was that financial restructuring did not happen overnight. Liberalizing the market was only the first step which had to be followed by wide-scale restructuring implemented mostly by privatization. The cleaning of banks' balance sheets from the accumulated non-performing loans of companies placed a heavy burden on the whole society. The timing of restructuring varied substantially in the region, nevertheless, sparing the reform and the capitalization of the banking industry was never a real option. Moreover, in the early years of the change, the lack of adequate financial institutions and expertise in lending activities along with the lack of supervision and legal backing made transformation also extremely costly.⁵

⁵ Hungary for instance chose the direct sale of state property in the banking sector. The cleaning of the balance sheets of banks was, however, always a precondition for successful privatization. Szapáry (2002) reports some estimates on the costs of banking reform in CEE countries. While in Hungary it accumulated at 13 per cent of the GDP in 2000 (and the reform of the banking sector indeed had been completed by then), the estimated costs in the Czech Republic peaked at 18 per cent of the GDP. Racocha (2003) claims that under the socialist rule banks indeed were severely undercapitalized. The ratio of capital to banks' assets did not achieve even the incredibly low level of 1 per cent. Hardly a big surprise that banking sector was probably the most badly hit sector in the early years of transformation.

The transformational recession hit the financial sector disastrously. Cleaning irrecoverable assets, capitalizing and privatizing the banking sector, the establishment of an adequate legal environment along with the introduction of safety regulations and accounting standards made credit constraint extremely hard for both companies and individuals in the region.⁶ Liquidity constraint, however, makes it impossible to experience non-Keynesian effects, as our theoretical analysis of Chapter 3 has documented it earlier. In the first phase of transformation, macroeconomic stabilization was a must, fiscal policy had to tighten its course, and accordingly, the standard Keynesian effects made their presence strongly felt, thereby further deepening economic stagnation. Transformational recession made it clear that only market economies with a certain level of development may be able to experience non-Keynesian effects in times of a fiscal consolidation.

5.3 Stylized facts of the CEE financial markets

While developments initiated in the last fifteen years attained the admiration of many, there still remained a lot to do. In its Financial Stability Report, the IMF (2005) for instance made the following comment on Hungarian financial developments: the financial system has been strengthened substantially and financial intermediation has become deeper throughout the years of transformation, but contrary to the extensive expansion of the financial system, it is still far behind that of the developed countries' standards. Generally speaking, financial markets in the region still suffer from the following shortcomings:

⁶ As far as the Hungarian case is concerned, according to Király (1995), besides the inherited bad portfolio, transformational recession aggravated the burdens of commercial banks substantially. There was no need for a bank panic in order for the financial institutions to suffer from a significant loss of their own capital as early as 1991. Nevertheless, the deteriorating trends became overt only by 1993, as the share of non-performing loans reached an unmanageably high level. Várhegyi (2002) estimated the share of *new* bad loans to be more than two-thirds of the total. As a corollary, banks were enforced to restrain credit supply considerably between 1992 and 1994, which in turn contributed to the deceleration of economic growth. See also Csaba (2005a) on this point.

- (i) The existence of a small market with a low degree of financial penetration (both in absolute and relative terms—compared to EU averages for instance).
- (ii) Capital markets and the non-banking sector are still underdeveloped, characterized by small size and low degree of diversification of products and low participation ratio.
- (iii) A more competitive banking market on the non-financial corporate sector and the relative insignificance of the households sector.

Commercial banks play a disproportionately large role in financial intermediation comprising around 80–90 per cent of the total financial assets in the region. The balance sheet structure of banks reflects resemblance to that of the EU-15's, especially due to the remarkable increase recently in household lending, inclusive of the expansion of mortgage markets. Nevertheless, by 2004, households accounted for 24 per cent of the total loans only in the new member states, showing a strong contrast with the extremely high portion of non-financial corporation loans at 52 per cent of the total (on average). Although households are still lagging heavily behind their Western counterparts as far as the asset side is concerned, they are rather strong on the liabilities side, representing two-thirds of the total liabilities (ECB 2005:6).

As far as capital markets are concerned, they simply did not exist in the region and financial services were provided exclusively by banks. Quoted equity and debt securities, therefore, lag heavily behind the banking sector. Even the relatively high return on equities has not made direct markets more attractive.⁷ Moreover, public companies are usually listed on the foreign stock exchange, since the mother companies are located elsewhere. Stock markets are, consequently, dominated by very few companies. As a result, the banking sector enjoys a quasi-monopoly position on the financial market.⁸ Nevertheless, Hungary is somewhat ahead of the others in the region which can be explained by

⁷ Nevertheless, non-quoted equity (such as family savings invested directly into an own business) plays a decisive role in investment decisions in the region. According to ECB (2005) estimates, its share in total equity financing is around 80 per cent.

⁸ See Szapáry (2002) for instance.

its willingness to embark relatively early on wide-scale restructuring of the whole financial system (banks possess only 69 per cent of total assets in the country). The bond market is still small in CEE, but more active than equity trade. Governments gave up debt financing by printing money relatively early. They turned towards capital (debt) markets, where they are the dominant players.⁹

Another specific feature of the CEE financial intermediation is the relatively large presence of foreigners mainly via subsidiaries. According to the ECB (2005), on average 72 per cent of total bank assets are under foreign control in the ten new members (in Estonia, foreign bank-ownership is nearly 100 per cent).¹⁰ As Mérő and Valentyi (2003:15) succinctly comments, in the case of CEE countries, “opening their markets for foreign banks represented the only possible way of creating an efficient banking system providing services that could meet international standards. Lack of domestic capital and expertise was made apparent by the massive losses of capital following the implementation of the two-tier banking systems and the subsequent transformation crisis.” Foreign banks contributed to an explosion-like increase in the range and quality of services provided by banks to privates which could soften *liquidity constraint* significantly in the last few years. In an empirical analysis, Drakos (2003) for instance demonstrated that foreign ownership in the banking sector intensified competition significantly which in turn improved the efficiency of the sector, especially through spill-over effects providing positive externalities for the whole economy.

5.4 Banking activity in a comparative perspective

In the following, a few main indicators will be reflected upon in a comparative perspective. Hungary’s banking activity will be contrasted with not just the aggregates of other Central European nations but also

⁹ Stock market capitalization in CEE countries was the following by the end of 2003 (numbers are in the GDP): 19 per cent in Hungary, 16 per cent in the Czech Republic, 17 per cent in Poland and only 4 per cent in Slovakia. Corporate sector debt securities are even less robust, being less than 4 per cent of the GDP in each of the selected countries (ECB 2005).

¹⁰ The main investors in the region have become KBC Bank, HVB Group, Raiffeisen, GE Capital, Citibank and Erste Bank.

Table 5.1 Banking assets and domestic credit

	Banking assets	Domestic credit	GDP per capita
Hungary	70	44	7847
Poland	56	27	4802
Czech Republic	103	29	7757
Greece	131	75	14950
Italy	167	87	23274
Ireland	436	138	34897
Spain	192	138	18870
Portugal	243	150	12882

Source: Merrill Lynch (2005).

Remarks: banking assets and domestic credit as percentage of the GDP. GDP per capita in US dollars. Data as of 2004.

with the former cohesion countries such as Portugal, Spain, Ireland, Greece plus Italy. Starting with one of the most often used measures, i.e. banking assets, the difference between CEE countries and the old member states of the EU are striking (Table 5.1). Only the Czech Republic was able to exceed 100 per cent, Hungary and especially Poland perform much worse. (Interestingly, the Hungarian figure of approximately 70 per cent has remained constant in the last ten years.) The outstanding ratio measured in Ireland is a relatively recent phenomenon: banking assets were less than 130 per cent in 1995 and only after that year did the ratio skyrocket. Portugal also successfully dynamized its banking activities starting from around 150 per cent in 1995 and culminating in almost 250 per cent a decade later. In contrast, Greece, Spain and Italy were able to increase its bank assets ratio by less than 50 per cent only in the last ten years.

Turning now to domestic credit, the overall picture suggests once again that a relatively low GDP reflects lower credit ratios. The reasons for the relatively low level of credit to the private sector in the region are manifold:

- (i) Large-scale privatization and the inflow of FDI created a strong and robust foreign-owned company base. These companies, however, borrow from their mother companies or home banks and do not apply for credit at domestic banks.

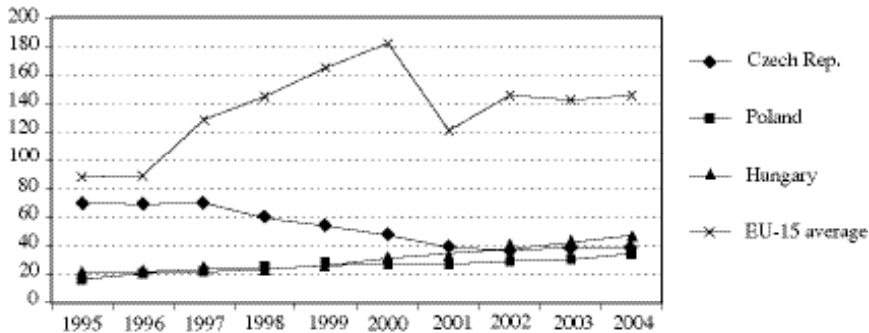
- (ii) Domestic private firms (especially SMEs) without an established and long track record have not been able to get access to credit facilities provided by the banking sector.
- (iii) Lending to households has been accelerated significantly in the last few years, but it is still very low as compared to EU standards mainly due to the still low level of household income and the relatively costly banking administration regarding the household sector.

The apparent contradiction between the relatively large Czech ratio of banking assets (as opposed to Hungary for instance) and the low Czech activity in lending is an interesting phenomenon. In spite of its robustness, it seems that Czech banks are still more cautious in lending than Hungarian ones. The reason for the much higher credit accessibility of Hungarian agents is mainly due to the previous successful restructuring of the financial sector, along with the cleaning of banks' balance sheets.¹¹ According to the estimates of Merrill Lynch (2005), by 2010, these diverging tendencies will be levelled both in the total banking assets and total credits. The hypothesis seems to be supported by the robust Hungarian credit growth experienced in the early 2000s, while, on the other hand, the Czech credit growth rate has deteriorated, providing a decrease. Data on total credit granted by domestic credit institutions are given in Figure 5.1.

The source of credit growth comes from both the domestic economy and more recently external sources. Interestingly, from a purely theoretical viewpoint, strong credit expansion would enhance the chance for experiencing non-Keynesian effects in times of fiscal consolidation, that is, credit expansion should be welcome. Nevertheless, an excessive credit boom can also facilitate a banking crisis (see especially the review of Kaminsky et al. 1998 and the study of Calvo and

¹¹ The Czech economy started the restructuring of the financial system relatively recently. The clearing of the major banks' balance sheets of bad debts and the subsequent privatization supported the improved performance of the financial sector from the late nineties, early 2000. Contrary to these relatively late developments, the Czech financial sector was always the largest one among CEE countries: the total assets in GDP was 135% in 2003, of which the banking sector amounted to 99.8%. See more in Racocha (2003).

Figure 5.1 Total credit granted by domestic credit institutions
(1995–2004)



Source: Eurostat (2005a).

Remarks: numbers as percentage of the GDP.

Mendoza 2000, among others). The high share of foreign-currency denominated lending makes the situation even more worrying (see the details in section 5.7).

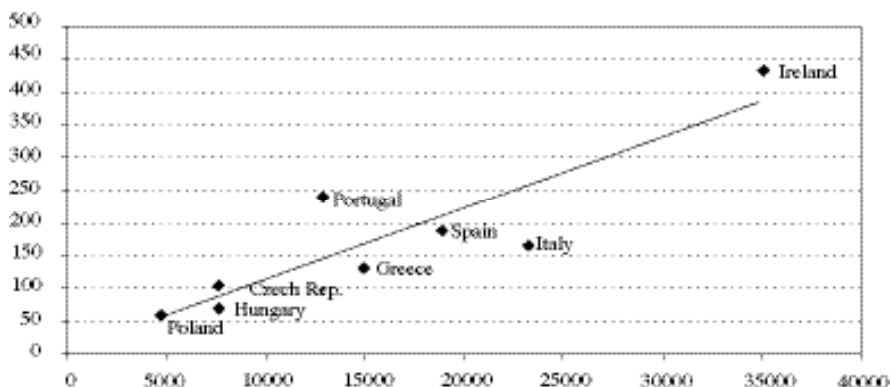
According to Kiss et al. (2006), the dynamic credit growth of CEE countries can be mostly rationalized by the process of catching up—an endogenous process of economic development. The authors also claimed that the credit-to-GDP ratios are still below that of what the economic fundamentals would allow. Accordingly, a further acceleration of bank credits can be expected in the longer run. Nevertheless, on a country-by-country basis, the results should make us more cautious. The rapid credit expansion in Latvia and Estonia has already pushed these countries off the equilibrium path of credit growth; in addition, the increasing indebtedness of the household sector in Hungary (mainly in foreign denominated currencies) should also be of a concern for policy makers.¹²

The real challenge for CEE countries therefore is to find the appropriate balance between an increased lending activity and to maintain a stable and sound functioning of the financial sector. Simply because it is more than likely that the forthcoming euro-adoption will intensify substantially credit growth in the region. Based on the earlier experi-

¹² By applying different assumptions, the simulations of Schadler et al. (2005) show a more robust growth in the lending activity of the next few years: a strong 35–45 per cent annual real growth rate has been predicted.

ences of the less-developed EU countries, the preparation for the adoption of the single currency and the introduction itself will expectedly further deepen financial intermediation. For instance, Brzoza-Brzezina (2005) demonstrated that the credit boom of the former cohesion countries (Portugal, Ireland and Greece) had already started 1–4 years before the EMU accession and peaked in the year of accession, producing an average 30–35 per cent increase annually. In some countries, the period following the euro-adoption saw a further increase in credit expansion. Evidently, the main beneficiary of the credit boom was the household sector, although the corporate sector absorbed most of the additional lending facilities in absolute terms. Financial intermediation has deepened significantly in countries such as Ireland and Portugal—the depth of intermediation has exceeded the European average indeed. More importantly, Brzoza-Brzezina (2005) also documented that the lending boom in these “old member states” did not undermine the stability of the banking sector. Banks remained profitable, and the capital adequacy ratio never dropped below 10 per cent during the years of the credit boom; the share of non-performing loans also remained insignificant (less than 3 per cent in the case of Ireland and Portugal). As a corollary, the author expects CEE countries to experience a significant credit boom in the near future, without posing real threats on the banking sector.

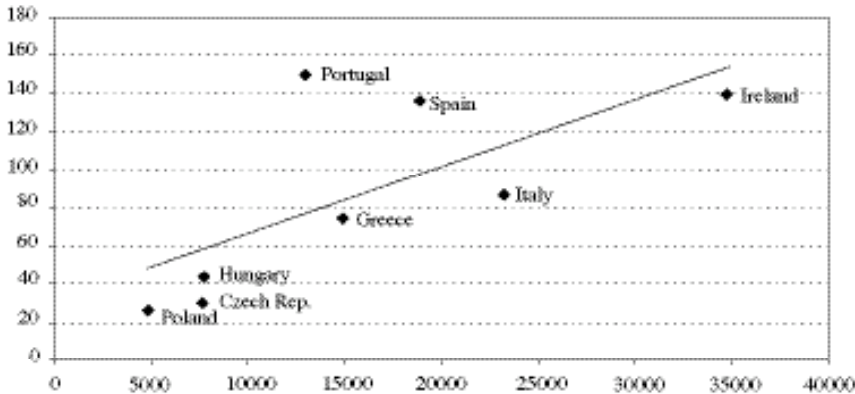
Figure 5.2a Development versus the degree of financial intermediation I: Banking asset penetration and GDP



Source: Merryll Lynch (2005).

Remark: data as of 2004.

Figure 5.2b Development versus the degree of financial intermediation II: Domestic credit and GDP



Source: Merryll Lynch (2005).

Remark: data as of 2004.

As Figure 5.2a and b demonstrate, the assumably above-EU average growth rate of CEE economies will raise their real income significantly as well. The relationship is nevertheless a two-way one: while financial intermediation as a means of remedying market frictions by lowering costs spurs economic growth, economic development also enhances the deepening of financial intermediation. A higher level of development can induce the proliferation of financial activities, including the expansion of credit allocation to households, an important means from the viewpoint of eliminating liquidity constraint. As a part of the real convergence process of transformation therefore, financial deepening will increase, too.¹³

The liabilities side of banks' balance sheets reflects similar tendencies to that of the asset side: robust growth in CEE, but still well behind the old member states (Table 5.2). The Czech Republic is well ahead of fellow countries with a total deposit rate above 60 per cent; the others stand at around 20 to 40 percent. Nevertheless, the savings market is well-penetrated in the region. What is worrying, however, is the weakness of the specific forms of customer savings, such as mutual funds, and life and non-life premiums. Presumably, the growth rate of deposits

¹³ See among others the excellent survey of Levine et al. (2000). In the context of Central and Eastern European countries, see M  r   (2003).

Table 5.2 Banking liabilities

	Deposits/GDP	Mutual fund assets/customer savings	Life premiums/ GDP	Non-life premiums/ GDP
Hungary	42	10	1.2	1.7
Poland	39	11	1.2	1.9
Czech Republic	61	7	1.6	2.5
Greece	85	19	0.9	1.2
Italy	54	34	2.7	4.9
Ireland	85	28	5.7	3.2
Spain	95	24	2.4	3.3
Portugal	92	15	4.7	4.7

Source: Merryll Lynch (2005).

Remarks: numbers are percentages. Data as of 2004.

will lag behind that of the credit side for a long time, but a significant rearrangement can be expected concerning the weights of offered products. For instance, if CEE countries will follow EU patterns, the share of insurance will increase substantially.

In sum, while there are diversities within the CEE region, both the assets and the liabilities sides of credit institutions show a significant backwardness as compared to the EU-15. Von Hagen and Dinger (2005), however, emphasized that the causes for the rather weak performance of CEE countries in financial intermediation cannot be narrowed down simply to the underdevelopment of their financial system. They claimed that the real reason for the relatively low performance of CEE countries has been due to the poor wealth status of households. By definition, financial intermediation is the interrelationship between savers and investors. Consequently, if households are relatively poor, financial intermediation cannot fulfill its task even if the sector is healthy and developed. It is superfluous to stress that CEE countries started the transformation process with a much smaller wealth than their Western counterparts and moreover, they experienced a fall in wealth at the beginning of the transformation. From this book's perspective, von Hagen and Dinger's (2005) claim is crucial since both modern consumption theory and the concept of non-Keynesian effects are conditioned on the current and prospective wealth status of households. According to Chapter 3, if a relatively large portion of the house-

holds follow the Keynesian rule-of-thumb in their consumption behavior because they do not possess positive net wealth, there is (theoretically) no hope for experiencing short-term expansionary effects in times of fiscal consolidation.

5.5 Hungary: the deepening of the financial sector

By restricting the focus on Hungary, this section will discuss the most recent trends of the banking sector, concentrating on the sectoral distribution of credit supply. At present, the banking sector is by far the most important player in the financial system—a general phenomenon in the region—with a share of 69 per cent of total assets. Pension and health funds experienced a remarkable increase in the last few years due to the introduction of the private pillars, reaching 6.2 per cent of the total assets by the end of 2004. Financial enterprises—mostly in car leasing and purchase—were able to double their share in the market and stabilized at a remarkable 7.6 per cent. See Table 5.3.

Table 5.3 Sectoral distribution of assets

	2000	2002	2004
Commercial banks	72.2	60.9	62.2
Specialized banks	2.0	8.6	7.1
Savings and credit coops	4.9	5.3	4.9
Pension and health funds	3.7	5.3	6.2
Mandatory	1.6	2.8	3.7
Voluntary	2.1	2.5	2.5
Insurance companies	6.6	7.1	6.6
Investment funds	5.1	6.4	5.0
Investment companies	1.6	0.6	0.3
Financial enterprises	3.9	5.7	7.6
<i>All financial institutions</i>	<i>100</i>	<i>100</i>	<i>100</i>

Source: IMF (2005:10).

Remarks: numbers as percentage of the total.

It is often claimed that the household market entails both more risks and more costs than any other segments of the financial market. As a matter of fact, in the first ten years of transformation the freshly privatized banks did not target households at all. While households were neglected

for most of the time in the nineties, foreign-owned banks turned towards enterprises and tried to compete with each other in this segment only.¹⁴ Móri and Nagy (2004) have also found that the relative underdevelopment of the banking sector and the consequent low level of financial intermediation as compared to EU standards can be traced back to the less intensive competition among providers. The high net interest margin and the outstandingly high profitability of banks may prove that financial intermediation has remained far from the Western standards.¹⁵ The almost sure profit in turn did not induce the banking sector to design less costly services for households, highly distorting individuals' decision by discouraging individuals from borrowing activities.

Households were left to the largest Hungarian bank, the National Savings and Commercial Bank (or OTP). According to Móri and Nagy (2004), the single beneficiary of the situation has been indeed the OTP. Evidently, the lack of interest of other banks in the household segment, thus, the concentrated power and the relatively low quality of services (along with the narrow product and service range) helped neither the development and expansion of household credit market, nor the creation of saving-awareness of individuals. Without a more significant access to financial markets, the existence of liquidity constraint in the first ten years of transformation seemed to be almost self-evident; it was indeed a general phenomenon in the country. The Keynesian behavior of households in those years therefore can be rationalized partly by the lack of credit institutions and facilities due mainly to the relative inactiveness of banks in this segment.

While until 1998/99 the household market was a stagnant and almost irrelevant one where banks did not put much effort in expanding their lending activities, the intensified competition in the corporate market sector on the one hand and the changed government policy regarding housing on the other hand altered the situation significantly

¹⁴ The tightened fiscal course from 1995–96 redirected the lending activity of commercial banks from the government to the corporate sector.

¹⁵ According to the estimates of the authors, in Hungary, the margin between lending and deposit was as high as 11.7 percentage points in 2002 on consumer markets. The same measure was only 5.1 in the euro area. The corporate sector, however, has been in a much favorable situation: the net margin was somewhat below the euro-zone statistics. The disproportionality indicated the relative market power of banks vis-à-vis the households very well.

later on. The banking sector's profitability started to swiftly decline in the corporate sector. In turn, financial institutions had to reconsider their earlier strategies considerably. This was also the time when households started to accumulate wealth, after a dramatic decline in their net wealth position, due to the austerity package of 1995. Árvai and Tóth (2001), for instance, explained the decrease in households' savings, experienced in the very last years of the nineties, not just by the acceleration of financial liberalization, but also by the increased permanent income prospects of households. According to the authors, the EU-accession, along with the real convergence process, induced individuals to save less. In 1999, household indebtedness (as a ratio in disposable income) started to rise again.

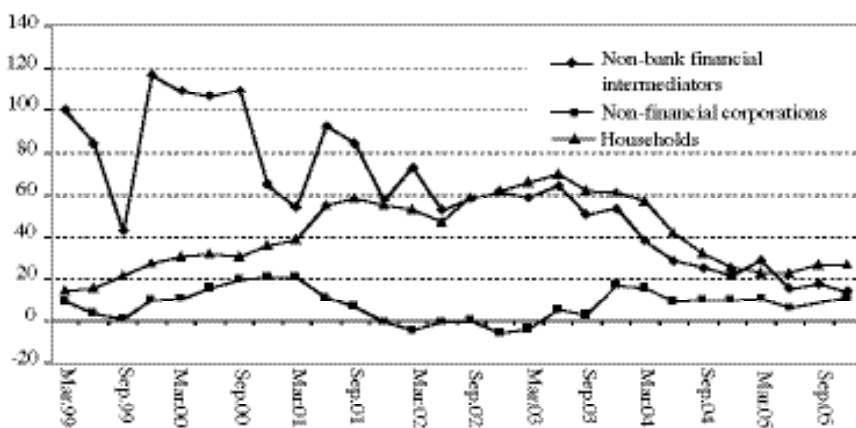
Árvai and Tóth (2001) reported that by the end of the nineties, more than half of the households belonged to the group of "financially relevant households," that is, households which already had some experience with the financial market. (Certainly, this ratio was still much below the standard of any developed market). One of their most interesting findings was that comparing the data of 1995 (the year of the austerity package) to those of 2000, a 20 per cent reduction was measured in the savings category of "unexpected events" and "sickness." A significant drop was also measured in savings for unemployed periods. On the other hand, there was a substantial increase in other categories, such as "buy, improve, upgrade homes" (more than 20 percentage points) and "retirement." Accordingly, the precautionary savings motive eroded substantially in Hungary as early as 1998/99.¹⁶

¹⁶ In fact, it is not evident at all whether it is due to the liquidity constraint or precautionary savings that people are not *able* to or are not *willing* to apply for credit at financial markets. Carroll and Kimball (2001) argued for instance that where liquidity constraint becomes binding, precautionary savings will also increase. The less wealthy a family is, the more binding the constraint and the more robust the precautionary saving motive can be. One of their most interesting claims is that the precautionary saving motive evolves because the constraint may soon become binding; therefore, consumers will defend themselves against the binding constraint by an increase in (precautionary) saving. "The fact that precautionary saving arises from the possibility that constraints might bind may help to explain why such a high percentage of households cite precautionary motives as the most important reason for saving ([as it was argued by] Kennickell and Lusardi 1999) even though the fraction of households who report actually having been constrained in the past is relatively low (Jappelli 1990)" (ibid. 2).

The real boost in the household market came only with the new millennium, however. Figure 5.3 convincingly documents that the period between 2000/01 and 2003/04 saw a dramatic increase in household credit that was mainly fuelled by the lax policy of the alternating cabinets in Hungary. Besides, several other factors played a role: the low initial base, the falling interest rates which induced households to consume more credit, the development of non-banking loans, and a changing lifestyle.

The robust growth of outstanding loans to the household sector was somewhat counterbalanced by the significant deceleration of lending to non-financial corporations, the sector which was the main beneficiary of lending activities in the last decade. While in 1995 the lending activity of commercial banks moved away from the government towards the corporate sector, households have become the main targets of lending from 2000/01 onwards. The total lending activity of banks has witnessed a steady growth rate above 10 per cent in the last couple of years. The slowing down of the growth rate of household exposure started in 2004 only, when households turned towards foreign denominated credits.

Figure 5.3 Annual growth rate of outstanding loans to the private sector



Source: HNB (2006).

Banks also seem to be less hesitant to provide *direct* access to consumers by opening more branches. Bank branch density is, however, still low in Hungary: with 1 unit per 9000 inhabitants, it lags far behind

the former cohesion countries.¹⁷ The introduction of the housing subsidy scheme in 2001 accelerated the process of branch-opening significantly. As a consequence, the acquisition of branches has become a strategic goal of financial institutions. Table 5.4 reports data on the institutional setup of banks and other credit institutions (CIs) in a comparative perspective. As the figures show, Hungary has indeed a leading position among CEE countries concerning the total number of CIs. If, however, the number of banks and especially bank branches come under scrutiny, the country's position does not seem to be that favorable anymore.

Table 5.4 Density of credit institutions

	Number of credit institutions	Number of banks	Number of bank branches
Hungary	218	31	1147
Poland	660	60	3119
Czech Republic	77	35	1670
Estonia	7	7	197
Slovakia	21	21	1057

Source: ECB (2005).

Remarks: numbers of CIs: data per one million citizens.

5.6 The housing market in Hungary

Normally, housing—usually financed by a mortgage loan—has an outstanding share in the asset portfolio of households, that is, it is highly relevant in formulating consumption-decisions. It was claimed accordingly in Chapter 3 that housing and mortgage markets provide possibly the easiest ground for testing the relevance and extent of borrowing constraints. As expected, the most impressive development in lending activities in the last couple of years was experienced in the mortgage market in Hungary, implying a possible easing of the liquidity constraint. The previously discussed credit expansion, however, was mainly accelerated by government-financed subsidies in housing market. The changed governmental attitude has ensured a leading position for

¹⁷ The estimation is from Móri and Nagy (2004).

the country in the region in both the primary and the secondary mortgage market. While the stock of housing debt did not exceed 2 per cent of the GDP until the end of 2001, four years later the ratio accumulated at 10 per cent already, showing a remarkable increase. Paradoxically, the success and proliferation of mortgage lending can mostly be rationalized by fiscal profligacy which gave a jump-start for banks and households to react immediately to the supportive schemes of the government.

Admittedly, during the nineties, the mortgage market was almost non-existent in the country—being largely responsible for the prevalence of the liquidity constraint.¹⁸ However, the new mortgage schemes introduced by the conservative cabinet in the early 2000s and extended by the socialist-liberal forces have changed the situation dramatically and induced a heavy over-borrowing in the sense that “the subsidy scheme was exhibiting a rather unusual feature: the interest burden of households was not sensitive to market rates; all interest rate risk was with the central budget” (OECD 2005c:106). Practically, it also meant that more households applied for a mortgage loan than what could be expected without the heavily subsidized facilities, causing a serious concern for the central budget and reflecting a non-sustainable future path. Based on calculations of the Hungarian National Bank, around 15–30 per cent of mortgage loans would have been used in private consumption between 2001 and 2003 rather than for buying existing houses without the over-subsidized loans (HNB 2004b).

The government was reluctant to take decisive actions during the election time of 2002 and even after in order to stop further deterioration in the fiscal balance. It was only in December 2003 when the cabinet finally admitted that without firm actions the consequence of over-borrowing would be catastrophic and reduced the interest subsidy dras-

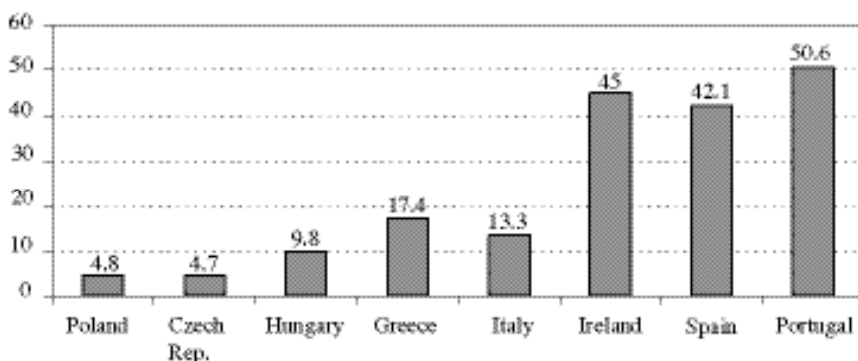
¹⁸ It is worth remembering that households did accumulate a significant amount of subsidized housing debt during the socialist era (around 6–7 per cent of the GDP in 1989/90), but after the change the ratio declined to below 1 per cent within a couple of years due to the early repayment schemes. The OECD (2005c) also documented that new housing loans simply did not appear on the market in the early years of the transformation process since long term contracts were considered to be highly risky. Even the government was not able to rely on long-term debt contracts up until 1996, when the first 5-year-long bonds were issued, and later on in 1999, when the ten-year debt obligations appeared on the market. The mortgage market was therefore strongly restricted by several economic and social factors.

tically. As a corollary, both the lending institutions and the borrowing individuals had to face a worsening in their net positions. Under the new scheme, mortgage rates have been partly linked to market rates and the subsidies became stricter in the case of buying existing dwellings. In turn, households have turned instead to foreign exchange denominated loans which offered a much lower nominal interest rate.

Turning to the comparative analysis of housing and mortgage markets, it immediately strikes the eye that CEE countries are in a much less developed stage than the old members of the Community. The EU-15 average of housing loans-to-GDP is almost six times higher than the ratio for Hungary, not mentioning Poland or the Czech Republic (see Figure 5.4). The pace of growth of housing loans in the region, however, outperforms the EU's average substantially (65 per cent versus 7 per cent).

Although with respect to the EU average CEE countries do not perform pretty well, Figure 5.4 also reveals that the ratio in Hungary is just slightly below that of Italy or Greece: mortgage credit accounts for only 13.3 and 17.4 per cent of the GDP, respectively. The down payment is indeed the highest in Italy (around 45–50 per cent) among the EU-15, making the mortgage loan less attractive for households. On the other hand, Ireland, the textbook example of non-Keynesian effects, as well as Spain and Portugal outperform new member states considerably with a 40–50 per cent mortgage-to-GDP ratio. All three countries apply variable interest rates (which converged to a relatively low level due to the euro-zone accession) and low down payments (20–30 per cent of the total). The preparation for EMU-membership accelerated mortgage market activity in these cohesion countries during the nineties, providing a significant above-10 per cent annual growth rate. The per capita measures of mortgage credit show an even worse situation in the three CEE countries (Poland, the Czech Republic and Hungary) vis-à-vis the four cohesion countries and Italy. In Hungary people owe their mortgage lending institutions 800 euro on average, while the Iberians for instance have to pay back 6500–7500 (Merryll Lynch 2005). Kiss and Vadas (2005) have therefore argued that several decades are needed to approach the equilibrium level of the mortgage debt-to-GDP ratio.

The most striking difference between Hungary and other new member states is, however, in the lending structure (see Table 5.5). Although mortgage banks and commercial banks have almost the same share in the Hungarian market, this is mainly because mortgage banks have

Figure 5.4 Mortgage credit

Source: Merrill Lynch (2005).

Remarks: numbers as percentage of the GDP. Data as of 2004.

been established as subsidiaries of the main commercial banks. In reality, mortgage banks (FHB, HVB and OTP) are not new players in the field. In 2003, for instance, the OTP Bank Group dominated almost two-thirds of the housing market. The relatively strong influence of mortgage banks is also due to the expansion of the secondary markets which made it attractive for specialized mortgage banks to take a role in lending activities. Establishing a functioning primary market for housing lending may not prove to be enough to overcome liquidity constraint. To some extent, secondary markets have an even more influential role in deepening financial intermediation. Nevertheless, while primary markets are growing extensively in the region, secondary markets are still lagging behind significantly.¹⁹

¹⁹ Hungary, the Czech Republic, Slovakia, Poland and Latvia run their own mortgage bond markets. In the first three countries, approximately two-thirds of mortgage loans are used to cover mortgage bonds. The Polish and Latvian ratios are however less than 4 per cent (OECD 2005c:27). The significance of mortgage covered bonds is increasing in the secondary Hungarian market, and recently it has become the second most important category of fixed-income instruments. The interest of foreign investors also increased in the last few years in this segment. Nevertheless, the liquidity of covered mortgage bonds is still far less than that of government bonds: the monthly turnover of the latter exceeds thirty times that of the covered bonds' (ibid. 28).

Table 5.5 Lending structure in some CEE countries

	Commercial banks	Mortgage banks	Depository institutions
Hungary	44	48	8
Poland	96	3	1
Czech Republic	72	28	0
Slovakia	87	10	3
Estonia	100	0	0
Latvia	99.9	0.1	0

Source: OECD (2005c:20).

Remark: data as of 2003; total: 100 per cent.

5.7 Vulnerability of the private sector

Before summarizing the main findings of Chapter 5 on the depth of Hungarian financial intermediation and its effects on households' borrowing constraints, it is worth underlining two additional and partly interrelated tendencies. First, fiscal laxity largely contributed to the credit availability of the household sector between 2000/01 and 2003/04, providing a positive shock in the lending market, thereby deepening financial intermediation in the country. Second, the restrictions on housing subsidies and the relatively high domestic interest rate from 2004 onwards induced consumers to borrow in foreign currencies, thereby substantially increasing the vulnerability of the households' portfolios, which still receive their earnings in domestic currencies. Accordingly, a negative shock would seriously undermine the financial position of Hungarian households and possibly the banking sector.

Credit availability was extremely constrained in the first ten years of transformation. The new millennium, however, experienced a significant increase in household lending, in response to the explosion of mortgage market and consumer credit supported by *fiscal laxity*. The new initiatives indeed have changed credit availability dramatically and induced a heavy borrowing in a large segment of the society. Generally speaking, a credit boom is normally triggered by supply-side factors such as increased banking activity, due to a deregulation of the financial system. This results in fiercer competition and/or a robust inflow of external sources, as it has happened in several emerging markets from South East Asia to Latin America. However, the

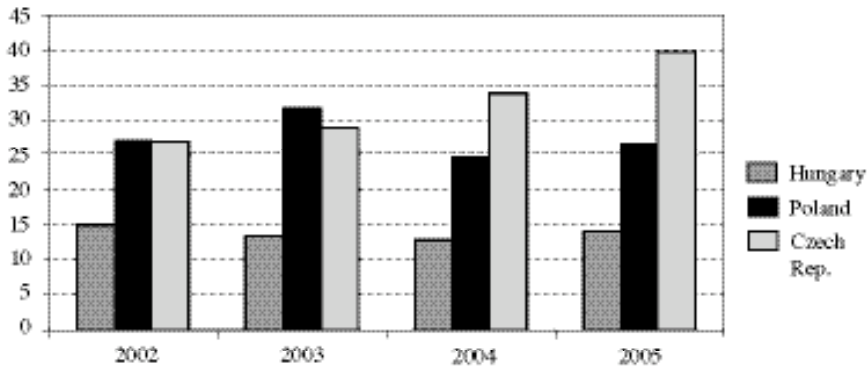
Hungarian situation differs from the textbook cases since it was the demand side that triggered a credit boom, making the liquidity constraint less binding.

Following the logic of the expectational view of fiscal policy, the easing of the liquidity constraint should make fiscal adjustment more appealing for politicians, in the sense that the possibility for the emergence of the short-term expansionary effects is higher than otherwise. Still, the alternating Hungarian governments have been reluctant to embark on a deficit cut in the last couple of years, although in principle the demand-side conditions for expansionary fiscal consolidations were better than ever before. But: we take the risk to claim that the sudden credit expansion (the easing of liquidity constraint) is in fact mostly due to fiscal profligacy and cannot be considered as an organic development process of financial markets. Furthermore, subsidized loans presented cause for concern for the central budget, reflecting a non-sustainable future path. It is worth remembering from Chapter 3 that the expectational view conditioned expansionary effects on the existence of *developed* financial markets or more precisely the lack of liquidity constraints. In Hungary, however, fiscal adjustment is needed partly because of the increased over-borrowing of households fuelled by fiscal laxity. At this point therefore it is not clear what effects fiscal adjustment would have on the household credit market. What we find here is a vicious circle. In Hungary a fiscal adjustment may weaken the possibility (and undermine the condition) of a full credit access of households, which in turn may lower the chance of implementing an adjustment with expansionary macroeconomic effects. This would in turn make it too costly for any politician to embark on reform—as long as the expectational view of fiscal policy is indeed correct.

Turning now to the other issue of this section, it can be claimed that today, one of the primary risks of the Hungarian financial system is the increasing share of foreign currency denominated borrowings of private agents, regarding both companies and households. Around thirty per cent of consumer credit is provided in non-forint denominated currencies. Companies' position is even worse in this respect: almost 60 per cent of their borrowings is in foreign currencies. Consequently, the vulnerability of the private sector is substantial. According to the HNB (2005a), three factors are determining in the increasing share of foreign currency borrowing: interest differentials, the low awareness of households, and the fierce competition among banks on the supply

side of credit. However, households usually make their borrowings without hedging positions, therefore the increasing exposure of households' balance sheets to foreign currencies would trigger a serious blow in case of a forint devaluation. Data are provided in Figure 5.5.

Figure 5.5 Share of FX loans in total loans to customers



Source: HNB (2006).

Remark: for 2005 data as of September 2005, except for Poland: December 2005.

A possible default of a great portion of households and small- and medium-sized enterprises on credit—due to a major devaluation of the Hungarian currency—would mean not just the likely increase of non-performing loans but also a significant loss of confidence of private agents in the financial system as a whole. With the increase of private sector borrowing, the vulnerability of the banking sector and indeed that of the whole financial sector will also grow. Fiscal policy and its performance therefore are indeed crucial in providing a healthy macro-economic environment, where private agents can engage in transactions without unnecessary risks.

5.8 Summary

Among others, Jappelli and Pagano (1989) showed that the excess sensitivity of consumption to current income fluctuations can be rationalized by the presence of the liquidity constraint. In countries where consumers can borrow less, people face the binding borrowing constraint more likely—a phenomenon that strongly correlates with relatively underdeveloped financial markets. In turn, in this chapter an

attempt has been made to highlight whether the Hungarian financial market (more precisely its banking sector) is developed enough to facilitate the emergence of expansionary effects in times of fiscal consolidation by eliminating credit constraint.

The analysis is encouraging. The consolidation of the financial market has taken a considerable time, just like in any other country in the region. The nineties can be characterized as a period of creative deconstruction, sweeping out the old and bringing in the new. The banking system emerged as the most significant player, surpassing direct financing sources. Albeit Hungarian financial intermediation is still lagging considerably behind Western standards, it stands a good chance of catching up in the not too long term.

Although the analysis of the sectoral distribution showed that consumers have an increasing accession to financial markets, it is worth noting once again what Japelli (1990) showed in his empirical study: consumers have a shorter credit history than companies, therefore, it will take some time for households to be able to realize the full potential of the market manifested in actual transactions. It was no big surprise that until the Hungarian government did not embark on extremely generous subsidies for households and raised real income, banks were basically more inclined to compete on the market of enterprise credit. Companies have been more creditworthy, that is, less risky and costly. Furthermore, while in corporate lending, financial institutions do share information among each other regarding the creditworthiness of enterprises, household borrowers do not have to be afraid of a collective action from the side of financial institutions yet. Only the largest players have adequate information about households, which makes them more confident in the retail market, while other banks have to take a much higher risk. These tendencies make the retail market more costly than it should be otherwise. In short, there is enough room for both banks and households to develop further ahead in this segment.

As it has been claimed earlier, it is likely that the forthcoming euro-adoption will extensify credit growth in Hungary (and other countries in the region). Based on the earlier experiences of the so-called cohesion countries, the preparation for the adoption of the single currency and the introduction itself will further deepen financial intermediation. Moreover, the assumably above-EU average growth rate of CEE economies will raise the real income of households significantly as well. Several empirical studies confirmed the existence of a positive

correlation between the level of economic development (measured by the GDP for instance) and the penetration of the financial sector. As a part of the real convergence process of transformation, financial deepening will hopefully increase as well, easing the liquidity constraint of households and in turn providing a better chance for non-Keynesian effects to be accommodated in the country.

In spite of the promising future, some facts also give cause to some doubts. In the last few years, the apparently stable and solid banking sector has moved vigorously towards households in its lending activity, providing two-digit annual credit growth rates. This household credit expansion coincided with the deterioration of external and internal equilibria. This coincidence became the most evident between 2001 and 2003/04. It seems reasonable to claim therefore that the ultimate reason for the accelerated credit expansion and deteriorated fiscal and external balance has been the lack of fiscal discipline, i.e. budgetary overspending. What we find here is a vicious circle. In Hungary a fiscal adjustment may weaken the possibility of a full credit access of households, which in turn may lower the chance of implementing an adjustment with expansionary macroeconomic effects. This would in turn make it too costly for any politician to embark on fiscal reform.

In the next chapter, therefore, by elaborating on the spending side of the budget, it will be pointed out that fiscal profligacy has indeed evolved mostly due to two items: household transfer and government wage consumption.

CHAPTER 6

The Expenditure Side of the Hungarian General Government A Decompositional Analysis

From the late eighties onwards, the study of the macroeconomic consequences of fiscal consolidation has become a popular field in academic research. This new stream of the literature does not only provide a positive study but also embarks on the normative research of fiscal adjustment. In line with the main findings of Chapter 4, there seems to be a widely shared consensus emerging in the developed part of the world, namely that the quality of adjustment *does* matter, or to be precise: it is not the size of adjustment per se that determines success in the reform of public finances but the *composition* of consolidation. While a focus on the overall balance and the figures related to total spending, revenue and debt is a good starting point, it is reasonable to assume that it is not really the balance, the stock of debt or the total amount of revenue and expenditure that is influenced directly by institutional and political factors but the composition of the general budget, therefore a disaggregated view has been adopted in this section.¹

This chapter does not concentrate on the pre-1995 period since this was the time of the transformational recession and the implementation of the trinity of stabilization–liberalization–privatization, which together

¹ Fortunately, international financial and monitoring institutions publish plenty of reports, assessments, statistical analyses on countries nowadays. The comparability of data, nevertheless, may still remain a serious concern in Central and Eastern European countries. In order to guarantee the highest degree of data quality, the following sources have been selected: the OECD's annual *Economic Survey* and the *Economic Outlook*, the European Commission's different reports (such as the convergence report), the IMF's annual *Country Report*, and the main reports of the Economist Intelligence Unit. Besides the resources of international agencies, reports of the Hungarian National Bank and the ÁHIR database of the Hungarian Finance Ministry have been used for specific purposes.

made the alternating governments highly reluctant to initiate any serious adjustment steps on the spending side of the general budget. In fact, public sector salaries and welfare provisions to households were almost untouched until 1995. The decompositional analysis will start accordingly with the 1995 austerity package, since this indicated the first clear attempt of politicians to embark on a more or less full-fledged consolidation effort in the field of public finances. Section 6.2 focuses on the period of 1997–2000, which reflected a relative calm with regard to public budgeting. Fiscal deterioration—starting in 2001—is analyzed in section 6.3. Section 6.4 elaborates on the failed adjustment attempts of 2003–2005, while the last section concludes. Importantly, the focus in the chapter is on the spending side of the general budget exclusively, since Chapter 4 concluded that expansionary effects can be expected to occur only if the politically sensitive items are tackled firmly by the government.²

6.1 The stabilization process: The years of the Bokros package (1995–1997/8)

The 1995 austerity program wished to restore the balance in both the current account and the fiscal position, thereby preventing a financial crisis similar to that of Mexico. The package that was introduced on 12 March 1995 tried to avoid an exclusively orthodox, restrictive approach, advocated mainly by international financial institutions such as the IMF, and adopted instead a heterodox package, combining the restrictive measures with structural policies as well. It was in fact a mix of large-scale macroeconomic stabilization efforts and microeconomic reforms. The tough measures did cause a slowdown in economic activity in 1995 and 1996, but they also paved the way for a sustainable future growth. Since the objective of this chapter is to evaluate the quality (or composition) of the general budget, the focus will be on fiscal measures only—the analysis of the other parts of the package will be left to other studies.³

² Admittedly, in the disclosure of public finances, a comprehensive study of both sides of the general budget would be the most fruitful. However, in the following, our focus will be on the expenditure side, since the ultimate aim is to unmask those political preferences which prevail in public spending.

³ See among others Antal (1998 and 2000), Csaba (1998), Kopits (1995), and Kornai (1996).

One of the main conclusions of Chapter 4 was that permanent debt-reduction and the emergence of expansionary effects in times of fiscal contraction can be expected to evolve if fiscal adjustment is initiated mainly on the expenditure side of the general budget. The architect of the program, Lajos Bokros (1996) argued accordingly that it was not simply the size of the deficit which caused serious concerns in the previous years but the extent of redistribution and the distorted structure of the general government. The deficient functioning of the budgetary institutions and the failed methods of deficit-financing further aggravated the problems. The break-up of the vicious circle of “either stability or growth” was possible to overcome only if each of these deficiencies were remedied sufficiently. Table 6.1 illustrates convincingly that 1995 was a decisive year in the course of Hungarian fiscal policy. It seemed that Hungary was able to join those countries where the rate of centralization was around 40 per cent, in line with the level of development.

Table 6.1 Main aggregates of the general government (1991–1996)

	1991	1992	1993	1994	1995	1996	1994–1995	1991–1996
Gross revenues*	52.4	63	50.9	50.4	44.5	42	-5.9	-10.4
Gross expenditures	55.4	69.2	57.5	58.7	50.9	45	-7.8	-10.4
Gross balance	-3.0	-6.2	-6.6	-8.3	-6.4	-3.0	-1.9	0
Primary revenues	50.8	61.8	50.0	49.2	43.8	40.3	-5.4	-10.5
Primary expenditures	51.7	63.5	53	51.9	41.6	38.9	-10.3	-12.8
Primary balance	-0.9	-1.7	-3.0	-2.7	2.2	4.4	-4.9	-5.8
Interest balance**	-2.1	-4.5	-3.6	-5.7	-8.5	-7.4	+2.8	+5.3

Source: based on OECD (1999:46).

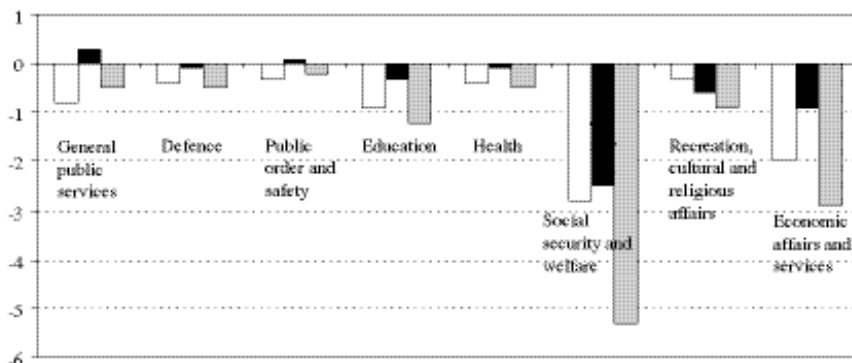
Remarks: *net of privatization revenues; **interest revenue minus interest expenditure.

As Table 6.1 depicts, the elimination of deficit-financing was achieved basically by dramatic cuts on the expenditure side of the general budget. Primary expenditures fell from almost 52 per cent to 41.6 per cent first in 1995 and further down to 39 per cent of the GDP one year later. Primary revenues fell somewhat also but to a much smaller extent than expenditures, which helped to improve both the primary and the general balance.⁴ The big picture was of course much worse, since gross expenditure (and the gross balance) was 8 per cent points higher, due to the extremely huge amount of interest payments in the year of the consolidation. Interest payments equalled to almost one-fifths of the total revenues in the years of the mid-nineties, which meant an explicit and painful burden for the country. The total balance would have been much more impressive in 1995–96, if the government had decided to spend privatization revenues to cover the current expenditure. Instead, extra revenues were rightly spent on debt reductions.

The ultimate goal of this chapter is, however, to decompose expenditures in order to identify those components of the budget which brought about the recovery (or the deterioration) of fiscal performance. Hopefully, by applying a disaggregate view, the political preferences of policy-makers will become recognizable. The decomposition of expenditures (between 1994 and 1997) can be seen in Figure 6.1.

One of the most striking features of the decomposition of expenditures is that each and every budget item decreased significantly after the launch of the austerity package. The Finance Ministry implemented an across-the-board-type cut in accordance with the double aim of reducing the deficit and curtailing irrevocably the size of the state. The most powerful decrease was measured in the following three areas: (1) recreation, cultural and religious affairs and services (witnessing an almost 50 per cent decrease); (2) economic affairs and services (44 per cent); and (3) defense (38 per cent). Certainly, the first element does not belong to the basic functions of the state, yet it might be an excellent field to

⁴ The decline in revenue was mostly due to the fall of income taxes and consumption taxes, a result of the substantial fall in the disposable incomes of individuals. Nevertheless, the introduction of import surcharge—an important element of the austerity package—supplied extra revenues (1.1 per cent of the GDP). Surprisingly, an increase was recorded in corporate taxes as well. According to the OECD (1997), a nominal fall of around 20 per cent of corporate taxes was anticipated due to the cuts in the enterprise tax rate, from 36 per cent to 18 per cent. However, revenues increased by 11 per cent in nominal terms.

Figure 6.1 Decomposition of public expenditures (1994–1997)

Source: OECD (1999:49) and own calculations.

Remarks: the first bar shows the changes between 1994 and 1995, the second gives information about the changes between 1995 and 1997, while the last bar measures the cumulative changes between 1994 and 1997. The changes measure the difference between the starting year and the end year, expressed in percentage points of the GDP.

enforce political influence in the process of redistribution. Publicly funded economic affairs and services can provide an ideal ground for patronage, too.⁵ The cutback in defense spending meant evidently the reduction of the out-of-date army assets and the drastic layoff of personnel.

Table 6.2 Changes in social security and welfare spending

	Change 1995/1996	Change 1996/1997	Per cent share in total social security outlays
Pensions	-5.1	2.2	60
Sick pay	-31.2	-7.4	3
Pharmaceuticals	-0.6	1.9	10
Public health	-2.2	-0.1	22.5
Operational expenditures	16.8	6.1	2.7
Other expenditures	8.7	-30.8	1.8
Total	-4.5	0.6	100

Source: OECD (1999:53).

Remarks: Changes in the first and second columns are annual percentage changes.

⁵ Economic functions such as price regulation and price subsidy, however, can also be interpreted as the welfare functions of the state in Hungary, as it has been documented in Benedek et al. (2004).

In absolute terms, however, it was the social security and welfare spending which suffered the most striking reduction (5 per cent of the GDP), which equalled to a substantial 27 per cent change on a year-on-year basis. The health care system had to face a 10 per cent (yoy) decline only, which was just half of the average reductions (18 per cent, yoy). Details are provided in Table 6.2.

In spite of the serious cutbacks, social security funds still produced a deficit. The distribution of the deficit of social funds makes the picture more complex, however: the pension fund provided a HUF 6bn surplus, while the Health Insurance Fund suffered a huge loss, totalling at HUF 56bn (OECD 1999:50). The reason for this drastic loss was manifold: individual payments lagged behind the planned amount, and spending on pharmaceuticals increased by an unexpected 7 per cent. The operational expenditure of the Health Insurance Fund had been increasing permanently (in real terms), irrespective of the launch of the austerity package. In 1996, the increase totalled at almost 17 per cent and one year later the rise was once again around 6 per cent.⁶ Until 1999, the two social security funds were under the control of trade unions which did not exercise self-restraint in their spending activities. Nevertheless, the funds lost their autonomy partly after the package since they had to submit their expenditure proposals first to the finance minister, who could thereby exert some (albeit not significant) control on the budget of the social security funds (see more in Chapter 7).

By reducing the entitlements, the Bokros package wished to eliminate the paternalistic nature of public spending and to redefine the relationship between the state and its citizens. The measures were comprehensive but to some extent ad hoc, some of which triggered serious opposition from wide segments of the society. For instance, a needs-based redistribution was adopted in family allowances; parts of the free dentist service were abolished or better targeted; tuition fee was planned to be introduced in the higher education, etc. The cabinet decided to increase the age of retirement, too. The share of the benefi-

⁶ Originally, social security funds were expected to report a balanced budget at the end of 1996 but the “poor collection record and a failure to recoup arrears” made this impossible and the deficit reached 1.1 per cent of the GDP (OECD 1997:39). Especially large, state-owned institutions and companies such as the police or the Ikarus bus-manufacturing company, failed to pay the mandatory social security contributions into the budget.

ciaries of the unemployment scheme, sick pay, early retirement, parental leave, etc. decreased slightly from the 1995 level of 24.2 per cent to 22.9 per cent in 1997—measured in the working-age population. The most evident reduction occurred in the field of sick pay and sick leave, where the number of entitled individuals decreased by 25 per cent between 1995 and 1997 (data in Table 6.3). Although the Constitutional Court vetoed some of the reform measures, which in total did not contribute significantly to the lowering of the deficit itself, the finance minister emphasized on several occasions that the basic aim was to change individuals' perception of the state. The package did not simply narrow aggregate demand but tried to demolish taboos, with respect to the free public provisions.

Table 6.3 Share of working-age population in sick pay and sick leave

	1995	1996	1997
Sick pay and sick leave	2.8	2.3	2.2
Sick pay	2.3	1.7	1.6
Sick leave	0.5	0.6	0.6

Source: OECD (1999:65).

Remarks: data are per cent of working-age population.

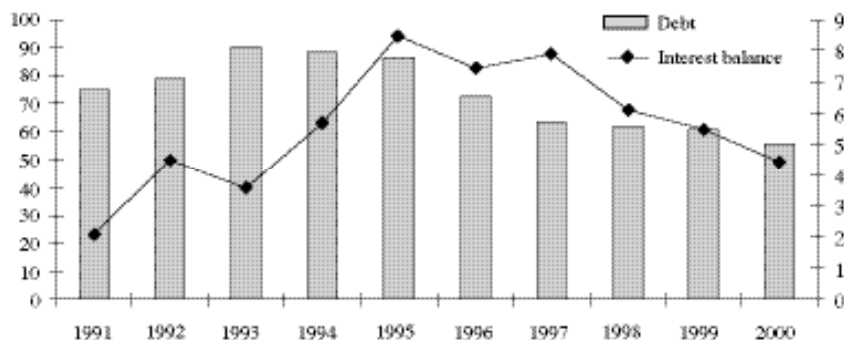
In accordance with the main findings of Chapter 4, the austerity measures wished to cut back the politically most sensitive items which were automatically inclined to increase, that is, household transfers and the public sector wage bill. While the former was not that successful (see above), the moderation of the wage demand brought remarkable results. In fact, one of the most important (and indeed most successful) elements of the heterodox program was the reduction of real wages by the induced surprise inflation that was not compensated by the government in social agreements. The cabinet imposed a wage freeze on nominal wages in the public sector, including state-owned companies, which had in turn an indirect effect on privately-owned companies as well, by increasing their cost competitiveness on international markets. The ultimate effect of the adjustment program on wages was around a 12 per cent fall in real terms, eroding the standard of living substantially.

According to the OECD (1997:41), “[t]he authorities have had considerable success in controlling and reducing expenditures. With the exception of the social security funds, budgetary outcomes have met or surpassed projections.” But the report also added that further reductions might have been hard to initiate because a large amount of expenditures (13.5 per cent of GDP) were taken out of the direct control of the central government, raising concerns about future stabilization efforts. The proliferation of extra-budgetary funds was indeed a peculiarity of the pre-1995 period of the Hungarian fiscal course. 29 funds were financed by public sources without the central government exercising a direct control on the spending of public money. The rule-of-thumb of the functioning of these extra-budgetary funds was rather simple: they could retain the surpluses but the central government had to cover the deficit each time, providing no incentives for the funds to adhere to fiscal discipline. The Bokros package reduced significantly the number of extra-budgetary funds to five and weakened their independence as well.

It was argued at the beginning of Chapter 5 that the period leading to March 1995 was heavily burdened with the heritage of the past, which was reflected in the survival of consumption orientation. The earlier unwillingness of cabinets to turn down this attitude resulted in the acceleration of indebtedness. In 1994, the general government’s gross debt accumulated to almost 90 per cent of the GDP. The 1995 program made an explicit attempt to reverse the deteriorating trends. The socialist–liberal cabinet decided to spend privatization revenues on reducing the stock of debt of the general government and thereby avoiding the finance of the current expenditure. The attempt to reduce the debt-to-GDP ratio was so successful that the Maastricht reference value of 60 per cent was achieved already by 1999 (numbers are provided in Figure 6.2). Interest payment decreased significantly from 1997 onwards; and consequently the general government balance improved.

The strong positive economic growth and the reduction of the debt-to-GDP ratio between 1997 and 2000 justified the idea that conducting a tight fiscal policy does not necessarily dampen the acceleration of economic activity in the medium and longer term. The break-down of the debt spiral of the early nineties was possible, however, mostly due to the extra revenues produced by the selling of state property. Yet, it

Figure 6.2 The evolution of the debt-to-GDP ratio and interest balance (1991–2000)



Source: EC (2005).

Remarks: debt ratio on the left scale, interest balance on the right scale. Numbers are expressed as percentage of the GDP.

was not just fund-raising that deserved attention with respect to privatization. The earlier practice of internal demand-based economic growth was replaced by an investment friendly, export-led growth regime. Privatization contributed largely to the restructuring of the micro sector. The inflow of FDI reached \$5–6bn per year, therefore there was no need to finance the current account deficit by debt-generating sources. The heterodox measures resulted in a highly competitive environment, thereby ensuring that Hungary was said to be the most successful transition country in the region in the next few years.⁷

⁷ The Bokros package was, however, not able to produce non-Keynesian effects, basically because of the strong decline of aggregate demand. As it has been claimed earlier, the package put the burden of adjustment mostly on households who in turn restrained their consumption spending dramatically and also increased their savings substantially. Rzonca and Cizkowicz (2005) have argued accordingly that it was indeed the boom of the Hungarian export sector that induced a relatively quick recovery in economic performance. Horváth et al. (2006) on the other hand put the emphasis on the surprise inflation, the devaluation of the Hungarian currency and especially the accommodating monetary policy by which the costs of fiscal contraction had been lowered substantially. That is, using the definitions of section 3.2, the adjustment can be best described as new-Keynesian, where the short-term costs paved the way for long-term sustainability.

6.2 After stabilization—before deterioration (1997 and 2000)

The effects of the stabilization measures of 1995 proved to be permanent, and the foundations for a long-term and sustainable economic growth were laid down. The measures were successfully mixed with some of the medium and long-term institutional changes (Csillag 2001: 831). Undoubtedly, the reform course initiated in the mid-nineties provided a good ground for further adjustments in the public sector (it is enough to mention the health care system, education or the civil service sector). However, following the 1995 austerity measures, the alternating governments were reluctant to initiate any further consolidation steps. In order to get an insight into the macroeconomic trends of fiscal policy, Table 6.4 displays some indicative numbers and their changes between 1997 and 2000.

Table 6.4 General government accounts, OECD basis (1997–2000)

	1997	1998	1999	2000	1997–2000
Gross revenues	45	44.9	44.8	44.5	-0.5
Gross expenditures	52.2	53.1	50	47.5	-4.7
Gross balance	-7.2	-8.3	-5.2	-3.0	-4.2
Primary balance	0.5	-2.2	0.3	1.4	+0.9
Interest balance	-7.7	-6.1	-5.5	-4.4	+3.3

Source: OECD (2002).

Remarks: numbers are as percentage of the GDP. Changes are measured as percentage points of the GDP.

The election year of 1998 reflects an evident loosening of fiscal policy. The real concern arises with the primary balance, where the discretionary actions and the political preferences of policy-makers can be touched upon. A 0.5 per cent sufficit in 1997 was changed to a significant loss (2.2 per cent) in 1998. Evidently, the 1998 deterioration was the result of electoral economics: the socialist–liberal coalition submitted the 1998 budget with the clear aim of vote-buying (EIU 1998:21–22). The parliament decided to increase pensions by 22 per cent (in nominal terms), and the public sector wage increase was set between 13 and 16 per cent. The health care sector also benefited from

election-year economics: in January 1998, it received HUF 1.5bn.⁸ However, the increase of extra spending did not stop after the Spring elections. The incoming conservative government deepened the deterioration of the general balance, too, with the bailing out of two banks—the Postabank (HUF 132bn) and the Hungarian Development Bank (HUF 50bn). The State Privatization and Holding Corporation received a substantial subsidy as well (HUF 50bn) and also local governments had to be compensated due to the privatization of the public gas utility. These one-off measures increased the deficit well above the planned targets (EIU 1999:26).

Generally speaking, despite the bailouts, fiscal policy was characterized by an apparent discipline under the conservative cabinet until 2000. Some minor changes were initiated between 1998 and 2000, but these basically left the main macro aggregates untouched. In accordance with the election campaign promises, some modifications and simplifications were adopted on the revenue side of the budget, in the way of a reduction in social security contributions paid by the employees and a shift towards family taxation. The slight fall of revenues, however, was compensated by several other measures. First, the government increased the motor vehicle tax fee and the tax on petrol. Second, the social security tax rate of employees was also raised by 1 per cent point (from 10 to 11) and most importantly, the tax base was expanded to incomes from in-kind fringe benefits (such as company cars) and dividend income. The collection of social security contributions was allocated to the national tax authority in order to increase the efficiency of collection. Another significant institutional change was the setting up of the armed investigatory department of the tax authority, the so-called Criminal Directorate. In fact, the economic growth was robust and sufficient enough to compensate for the relative loss in tax revenues. The operation of extra budgetary funds was rationalized, too, by reducing the numbers of operating funds and integrating them into the central budget. Four out of six were suspended.⁹ The government decided to postpone some investment projects, too, by which the

⁸ The 1998 aggregate numbers were negatively influenced also by the fact that the mandatory private pension scheme (the funded pillar of the system) was launched in the same year. New entrants to the labor market had to choose a private institution, while joining was optional for the others (up to the age of 47).

⁹ The four extra budgetary funds which were integrated into ministries under the central government were: the Road Fund, the Water Management Fund, the Central Environment Fund and the National Culture Fund (EIU 1998).

liabilities of the government could be scaled down significantly.¹⁰ While in the case of the termination and/or postponement of public investment projects one could argue that these were necessary steps in order to save public money, the postponement of the one per cent point increase of individual contributions to the private pension funds was evidently a flawed political decision that threatened the sustainability of the whole pension system. In total, these modifications seem to be minor, but the 1999 budget already demonstrated a rather significant change in the political priorities of the new government: benefits went to families,¹¹ the middle class earners, agricultural and rural employees,¹² small and medium-sized enterprises,¹³ and education and culture.¹⁴

Taking a look once again at the main macro data of 2000 on the fiscal position (Table 6.4), the overall picture suggests that everything seemed to be all right. The primary expenditures fell to the 1997 level again, a year when the blessed effects of the Bokros package were still alive. The exceptionally high 1998 data (45.2 per cent) in the primary expenditure proved to be temporary only. Since the interest balance recovered greatly up to 2000 (it was 4.4 per cent in the year of millennium), on the surface a healthy and stable fiscal performance was visible, where the deficit of the general government coincided with the Maastricht reference criterion of 3 per cent. Moreover, the Hungarian

¹⁰ The metro project in Budapest was terminated, saving HUF 200bn. The construction of the planned hydroelectric plant at Bős was also swiped off the agenda, which saved a total sum of HUF 600bn.

¹¹ Under the socialist–liberal coalition a so-called “needs-tested” system was exercised in the family support schemes. However, the new government reshaped the family allowances, childcare and maternity benefits, etc. since the incoming conservatives wished to widen the number of beneficiaries significantly, as they had promised earlier in the elections. One of the new elements was that those children who were enrolled in a higher education institution became eligible to receive some subsidy, too (EIU 1999:24).

¹² The budget of the newly established ministry (Agriculture and Rural Development) was increased by 40 per cent, compared to the level of 1998.

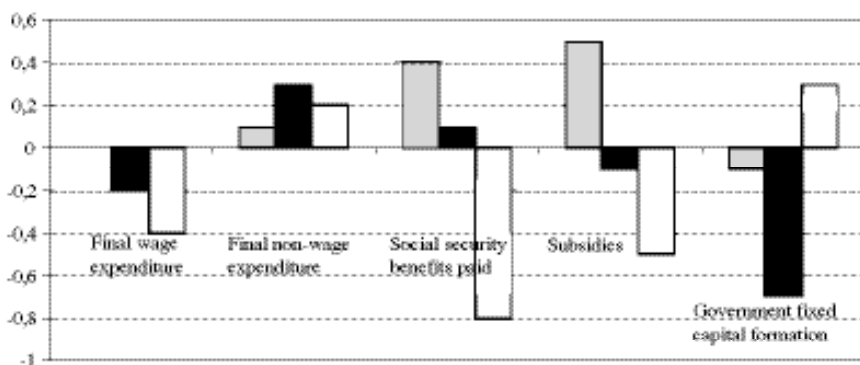
¹³ Small and medium-sized enterprises received a one-third increase (EIU 1999:23).

¹⁴ The newly established ministry, the Ministry of Cultural Heritage was voted two-thirds increase compared to the 1998 draft—preferred areas included the millennium celebration (HUF 15bn) and the subsidization of church operations (17bn) (EIU 1999:24).

economy performed its best data on economic growth in 2000: 5.2 per cent on an annual basis. It would have been hard to argue that Hungary could have done even better.¹⁵

The decomposition analysis highlights the main trends in spending between 1997 and 2000. Figure 6.3 confirms the claims made earlier, namely that it was 1998 which witnessed some laxity of fiscal policy, while 1999 and 2000 showed a more balanced evolution of fiscal measures. The most interesting changes occurred in the fixed capital formation. Both the socialist-liberal and the right wing cabinets promised the initiation of wide-scale investment projects, yet the cumulative change of fixed capital formation fell by 0.8 per cent of the GDP between 1997 and 1999 and the negative trend was reversed only in 2000. That is, the conservative cabinet chose the least political sensitive method of fiscal restriction: the postponement of investments.

Figure 6.3 Decomposition of public expenditure (1997–2000)



Source: OECD (2000:64; 2002:41) and own calculations.

Remarks: the first bar shows the changes between 1997 and 1998, the second gives information about the changes between 1998 and 1999, while the last bar measures the change between 1999 and 2000. Changes are expressed in percentage points of the GDP.

A significant decrease was also attained in government wage consumption, as a result of layoffs in the public sector. According to the OECD (2005d), public employment was still around 814 000 in 1997,

¹⁵ In fact, the critical tone of Hungarian experts was basically due to the dissatisfaction with the lack of commitment of the Orbán cabinet to further reforms in the general budget and not due to the overall economic performance, which was rather appealing in any comparison.

Table 6.5 Change in social security funds

	Revenue			Expenditure	
	1998/1997	1999/1998		1998/1997	1999/1998
Employer's contributions	4.7	-5.2	Pension	14.1	4.9
Individual contributions	-0.4	0.9	Sick pay	0.5	9.2
Health-care contributions	14.2	55.3	Pharmaceuticals	19.2	-5.6
Collection of arrears	30.0	-51.6	Public health	-0.1	4.0
Other revenues	12.9	201.2	Operational expenditures	9.1	-10.8
			Other expenditures	-9.3	6.1
<i>Total</i>	<i>5.8</i>	<i>7.1</i>	<i>Total</i>	<i>8.1</i>	<i>3.5</i>

Source: OECD (2000:69).

Remarks: real annual percentage changes (1995 prices), GFS basis.

this fell below 800 000 by 1999 (for a more detailed discussion see section 6.3.1). Nevertheless, the balance of final consumption remained virtually unchanged, due to the slight increase of the final non-wage consumption. Social security benefits did not change in total throughout the years, but the balance displayed a permanent deficit.¹⁶ Pension expenditures increased the most, by 14 per cent in real terms in 1998 for instance. One year later, the real growth in pension expenditure slowed down to 5 per cent, as a consequence of the flawed freezing of employees' payments contribution to private funds at 6 per cent. After a slight decrease in 1997, sick pay and sick leave shot up again significantly in 1998 and 1999.¹⁷ If the government would not have sold out its social security wealth, the total loss in social security funds would

¹⁶ The deficit of the social security funds was 0.6 per cent of the GDP in 1997; and 0.9 and 0.4 later on, measured on a GFS basis (OECD 2000 and 2002).

¹⁷ Pharmaceuticals and operational expenditures corresponded evidently to election year economics in the health care sector. (Pharmaceuticals amounted to 7.7 per cent of the total social security expenditure, while operational costs were 1.9 per cent of the total sum in 1999 (OECD 2000)). Spending on pharmaceuticals increased by more than 20 per cent in real terms in 1998, while there was a decrease in 1999 by 5.6 per cent (yoy). As far as

have been 1.1 per cent of the GDP in 1999 (details in Table 6.5). That is, the cabinet chose once again the politically less risky way to consolidate the budget: by selling off state property, instead of embarking on the reform of the welfare system.

Table 6.6 State aid

	1993	1994	1995	1996	1997	1998	1999	2000
<i>Central budget</i>	3.4	4	3.5	3.3	2.9	3.3	4	4.7
Agricultural subsidy	0	1.7	1.3	1.3	1.0	1.1	1.2	n.a.
Railway production subsidy	0	0	0	0.7	0.7	0.7	0.7	0.5
Indirect subsidy to households	0.9	0.8	0.8	0.8	0.8	0.7	1.8	0.6
Capital transfers to enterprises	0.1	0.2	0.3	0.6	0.4	1.8	0.9	1.9
<i>Extra-budgetary funds</i>	0.5	0.9	0.5	0.1	0.2	0.2	0.1	0.1
<i>Social security funds</i>	1.5	1.6	1.5	1.5	1.4	2	1.9	1.9
Pharmaceutical subsidies	1.4	1.4	1.3	1.2	1.2	1.2	1.2	1.2
<i>Local governments</i>	0.4	0.5	0.5	0.5	0.4	0.4	0.4	0.4
APV*	—	—	—	0.6	0.3	0.4	0.8	0.4
General government (total)	5.9	7	6	5.9	5.2	7.6	7.2	7.4

Source: OECD (2002:79).

Remarks: General government data, per cent of the GDP.

*: State Privatization Agency

Nevertheless, the successful maintenance of an apparent fiscal discipline in the late nineties was possible because interest payment fell substantially. Privatization revenues were spent on debt reduction after

the operational expenditures are concerned, the trend was the same: a 9.3 per cent increase first which was followed by a huge decrease of 10.8 per cent one year later. On the revenue side, the contributions to the health care fund improved substantially: they grew by more than 14 per cent in 1998 and crept above 55 per cent in 1999. Other revenues also showed a striking increase in 1999, as a result of the sales of government assets (0.7 per cent of the GDP).

1995, in turn, the interest burden lowered significantly, leaving room for the maneuvering of the (new) government. From an extremely high level of 8.2 per cent (of GDP) in 1997, interest payment slowly fell first to 6.5 per cent in 1999 and then to 4.8 per cent in 2000.

The intensified use of state aid in subsidizing enterprises was, however, a relatively new phenomenon. The most important one was capital transfers (equity investments) in government-controlled enterprises. Earlier, the Bokros package reduced state aid substantially (from 7 per cent of the GDP in 1994 to 5.2 per cent in 1997), but the trend was reversed in the late nineties and stabilized above 7 per cent again reflecting some loosening of fiscal discipline (see Table 6.6 for details).

6.3 Bringing back the past—the revival of fiscal indiscipline (2001–2004/05)

Unfortunately, the first half of the 2000s witnessed a strong deterioration of the Hungarian fiscal balance, which made the relatively early adoption of the single currency unlikely. The large deficit in the gross balance and the increasing debt-to-GDP ratio both showed serious overruns in public spending, clearly reflecting the lack of fiscal discipline. Concentrating on the gross balance first, it seems that fiscal policy was able to practice some self-restraint in 2000 and 2001, albeit some worsening did occur. 2002 provided, however, a record high deficit in the country which was reduced somewhat in the next few years but the general balance has been still very far from the Maastricht reference value of 3 per cent of the GDP. Even more, the required declining trend cannot be touched upon in the numbers; year 2005 experienced a higher deficit than a year before and projections of international institutions such as the European Commission for 2006 do not expect the deficit to decline either.¹⁸ The official data on fiscal balance, shown in Table 6.7, have been corrected by payments to the second pillar of the pension system. Without these corrections, the fiscal deficit would be even worse (see Figure 6.4).

The large deficit numbers also reveal a positive fiscal demand impact by which the alternating governments were able to increase the income of the household and business sectors artificially. According to the

¹⁸ According to the latest estimates, the end-year total (uncorrected) deficit for 2006 is 10.1 per cent of the GDP.

estimates of the HNB (2005b), the broadly defined government sector (ESA-95 accounts modified by quasi-fiscal activities and other adjustments) induced a discretionary easing of around 1.8 per cent and 4.3 per cent of the GDP in 2001 and 2002, respectively; while 2003 and 2004 witnessed a 0.4 and 0.6 per cent restriction, respectively. 2005 and 2006 are expected (estimated) to provide an artificial boost once again by 1.0 per cent of the GDP in both years.

Table 6.7 General government's position (2000–2005),
EDP notification

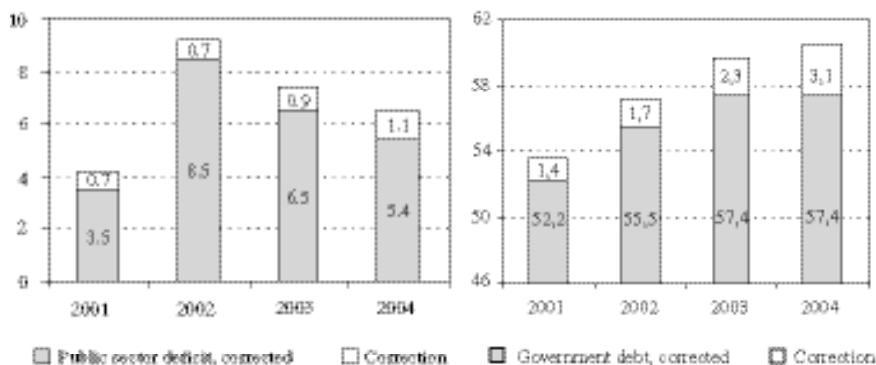
	2000	2001	2002	2003	2004	2005
Gross revenues	44.6	44.9	44.1	43.9	44.5	43.4
Gross expenditures	47.7	48.5	52.6	50.4	49.9	49.5
Gross balance	-3.0	-3.5	-8.5	-6.5	-5.4	-6.1
Primary balance	2.6	1.2	-4.5	-2.4	-1.1	-2.2
Interest balance	-5.6	-4.7	-4.0	-4.1	-4.3	-3.9

Source: EC (2005).

Remarks: numbers are as percentage of the GDP. Negative numbers indicate a deterioration in balance. The 2005 data are estimates.

The Eurostat granted a transition period for some countries (such as Hungary, Poland, Sweden and Denmark) during which payments to the private pension funds can be classified inside the general government sector until the March 2007 EDP notification. Accordingly, the Hungarian official general government deficit and debt figures were reduced by the estimated impact of the pension reform.

Figure 6.4 Fiscal performance of the general government,
EDP notification (2001–2004)



Source: Eurostat (2005b).

Remarks: data are per cent of the GDP.

The large deterioration in the general and the primary balance occurred mostly in 2002, with a corrected deficit of 8.5 per cent. (Primary balance was in surplus before 2002 and it turned into a heavy deficit of 4.5 per cent of the GDP in the same year.) The drastic overspending induced a rise in the debt-to-GDP ratio as well: it climbed to a corrected 55.5 per cent by 2002. Admittedly, a large part of the increase in the deficit and debt was due to one-off measures and debt transfers inherited from the previous government—estimated to be around 2.9 per cent of the GDP on ESA95 basis. The main one-off measures (mostly share acquisitions and debt adoptions) covered the following state owned companies: the NA Rt, the ÁAK Rt (both motorway companies) and BKV Rt (Budapest public transport company). The debt of these corporations and those of other smaller companies was taken away from the Hungarian Development Bank. The Hungarian Railways and the Budapest Arena were also among the bailed out corporations. Nevertheless, since the original deficit target was 4.9 per cent, the remaining 2.3 percentage point rise of discretionary spending shows a dramatic erosion of fiscal discipline.

It was not just a rise in the deficit that caused serious concern, but the increase of the size of the state. Both centralization and redistribution rose substantially in the last few years, starting at the end of 2000. One of the main results of the Bokros package was the reduction of the magnitude of state paternalism. Just to remember: the gross revenue was 42 per cent of the GDP, while gross expenditure stood at 45 per cent in 1996, while they climbed to 44.1 per cent and 52.6 per cent respectively by 2002. After half a decade, having experienced a robust economic growth—thereby increasing the denominator of these ratios significantly—the state started to expand again and restricted the scope of individual choice. With a redistribution ratio of around 50 per cent, Hungary once again joined the club of the richest European countries which collected and redistributed around half of their national income. Strange but true: the EU-15's average total outlays were 2 percentage points lower than the Hungarian 49.9 per cent (measured in GDP) in 2004. Only countries such as Sweden, Finland, Denmark Belgium, France and Austria—countries long known for their generous welfare state models—could outperform Hungary in this respect. The new CEE-8 member states' average on redistribution was much below the Hungarian data, at 41.8 per cent of the GDP. Numbers on the degree of centralization provide almost the same picture: total revenues in Hungary

greatly exceeded the CEE-8 average (44.5 per cent versus 39.5 per cent) and even the EU-15's average is only a slightly bit above that of the Hungarian measure (45.3). Numbers are provided in Table 6.8.

Table 6.8 Fiscal measures in a comparative perspective

	Hungary	CEE-8	EU-15
Total expenditure	49.9	41.8	47.9
Total revenue	44.5	39.5	45.3
Balance	-5.4	-2.3	-2.6
Debt	57.4	31.2	64.3

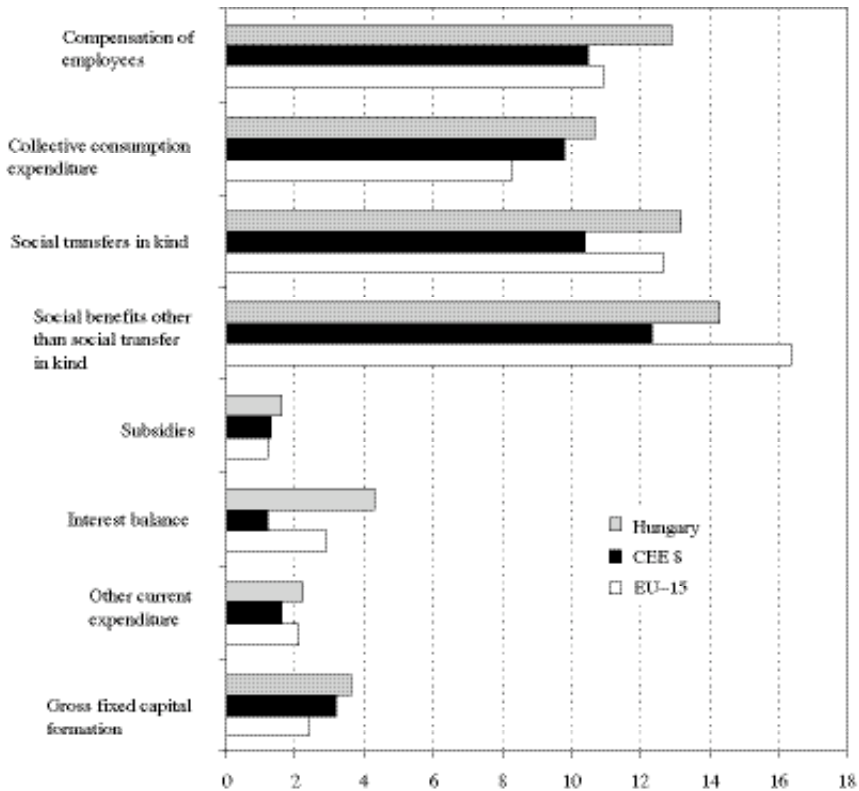
Source: EC (2005).

Remarks: numbers are in percentage of the GDP. Data as of 2004.

The ultimate aim of this section is to apply a disaggregate view in order to identify those elements of the budget which caused the serious deterioration in the fiscal balance (and the debt position) in the last few years, thereby delaying euro-adoption. First, such a disaggregate approach will be conducted in a comparative perspective, contrasting Hungarian fiscal performance with that of the EU-15 and the CEE-8 averages. Next, the discussion will be limited to the Hungarian events exclusively. Figure 6.5 depicts the distorted structure of the Hungarian budget in a comparative perspective. The data explicitly show that Hungary has spent significantly more on every major budget component than Central and Eastern European nations. More surprisingly, only in the sphere of "social benefits other than transfers in kind" does the EU-15 provide a more generous supply than Hungary. In every other segment, Hungary leads the way.

Even such a simple comparison well illustrates that labelling Hungarian public finances as deteriorated can mean at least two (interrelated) things: (i) the size of the state is much larger than it should be; and (ii) the structure of the general government suffers from serious distortions as well. As far as the structure is concerned, the most critical item is final consumption, especially wage consumption. Measured in the GDP, Hungary spends two percentage points more on the compensation of public sector employees than EU-15; in other words, it spends proportionally one-fifth more on wages than the old member states. The public sector in general performs rather inefficiently in the country (see more on this in section 6.3.1).

Figure 6.5 Comparison of general government spending in 2004 by economic decomposition



Source: EC (2005).

Remarks: numbers are as percentage of the GDP.

The effective functioning of a country can be proxied by the level of the collective consumption expenditure which reflects the cost of managing and regulating the society, the maintenance of law and order, the provision of security and defense or healthcare, the maintenance of environmental protection and research and development.¹⁹ Hungary here once again performs rather generously. It spends almost one percentage point more than the CEE-8 and more surprisingly

¹⁹ The definition of collective consumption expenditure is the following: services that are provided simultaneously to all members of the community or to all members of a particular section of the community.

almost two and a half percentage points more is spent in Hungary than in the EU-15. Unfortunately, the bulk of the expenditure goes to the management and regulation of the society, instead of financing R&D or environmental protection, items which would clearly mean investment in the future.²⁰

Concentrating on the dynamism of public spending, nothing surprising can be depicted. The permanent overrun of expenditures, causing a serious blow to projections on general balance, can be explained by several factors. From a bird's eye view, each and every single major component of the general government increased more than the GDP (in real terms) between 2000 and 2003. The most robust increase was experienced especially in two fields: public sector wage consumption and households' transfers. By numbers: compensation of employees increased first by 0.7 per cent (of the GDP) in 2001 and later by 1.1 and 1.0 in 2002 and 2003, respectively. Social transfers in kind rose by 0.3, 1.0, 1.0 in the same years. Social benefits other than social transfers in kind were increased by 0.1, 0.7 and 0.6 per cent in the three years under analysis. As it has been documented in Chapter 4, these items are automatically inclined to rise and since these elements are usually tackled as *entitlements*, it is almost impossible to reduce them because the political costs of a cutback might be too high. Household transfers and the public sector wage expenditure—the politically most sensitive items of the budget—amount to 60 per cent of total outlays or two-thirds of the current expenditure. Without their substantial reduction no real breakthrough can be expected in meeting the Maastricht criteria.

In order to uncover the main sources for overspending in these two specific spheres, that is, public sector wage expenditure and household transfers, a functional decomposition of the general government spending will follow. According to the classification of the functions of government, four main categories comprise the general government:

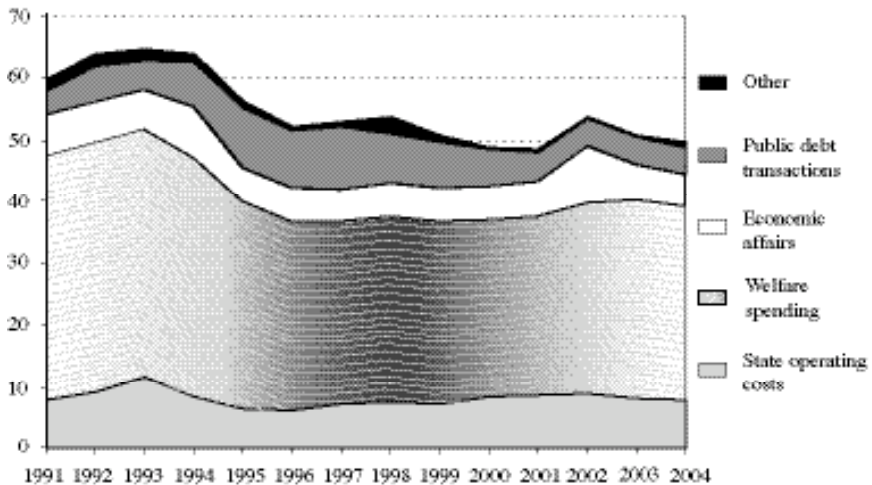
- (i) state-operating functions (such as the general public services, defense and public order and safety);

²⁰ Spending on environmental protection for instance never exceeded 1 per cent of the GDP in the last fifteen years in Hungary. The highest portion was spent in 1998 and 2002 (0.99 per cent), while 2004 witnessed a dramatic decrease, falling to 0.69 per cent of the GDP. (Data are from the ÁHIR database, Finance Ministry 2005.)

- (ii) the welfare functions (such as education, health care, social protection, housing, recreation and environmental protection);
- (iii) economic functions (such as energy, mining, travelling, telecommunication); and
- (iv) public debt management.

The data cover the period of 1991 to 2004 in a comparative manner, following the several corrections made by the Hungarian Finance Ministry.²¹ Numbers are recorded on a cash basis instead of the more general, accrual-based ESA95 methodology. The functional decomposition of public spending, unfortunately, has not yet been provided in accrual-based accounting for such a long period. Figure 6.6 demonstrates convincingly that both welfare spending and expenditures related to the functioning of the state started to grow after the millennium. Albeit their share is still below the 1993 figures, their increase is evident.

Figure 6.6 Functional decomposition of public expenditure



Source: Finance Ministry (2005), ÁHIR data base.

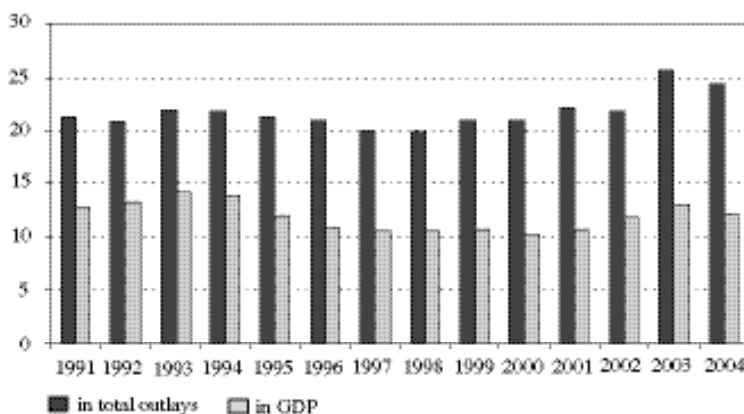
Remarks: numbers are in percentage of the GDP.

²¹ The data were generously provided by the Hungarian Finance Ministry.

6.3.1 Wage policy and public sector employment

If the task were to identify the most relevant factors in the deteriorated position of fiscal balance, it would be highly likely that the analysts would choose the failed wage policies of alternating governments in the last few years. The increasing weight of compensation of public sector employees in the budget—which was just slightly above 20 per cent of the gross expenditure in 2000 and climbed step-by-step to above 25 per cent by 2003, causing a robust increase in both relative and absolute terms—was the result of a series of deliberate official decisions, embedded in a more complex set of wage policy measures.

Figure 6.7 Compensation of public sector employees



Source: Finance Ministry (2005), ÁHIR data base.

Remarks: numbers are in percentages.

The share of compensation of public sector employees is like a roller coaster ride on Figure 6.7. In 1993/94 it reached its first peak, followed by a significant reduction from 1995 onwards. After the record low of 1997/98, the public sector wage bill started to accelerate to new record highs again: 25 per cent of the public expenditure was paid on salaries in Hungary in the last couple of years. The surge in the compensation of public sector employees was mainly due to the increased weight of those public sector servants who filled the state administrative positions, especially in the executive and the legislative branches (in other words: personnel outlays did not increase because more people were

employed in education or research and development, sectors where efficiency considerations could have explained the increase to some extent). In fact, in Hungary around one-fifths of the total public expenditure goes to state administration functions and more than one-third of the total compensation of public employees is used by the state administration—consisting of such functions as general public services, defence, and public order and safety.

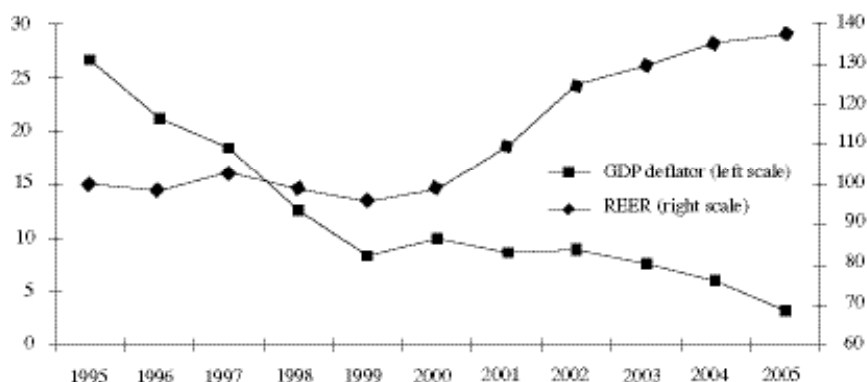
It was shown in Chapter 4 that certain demand-side decisions, such as the change of wage consumption of the general government, can have significant supply-side effects, triggering a change in business profit and private investment (recall the flow chart of Figure 4.1). The early years of the 2000s witnessed a serious demand-side impetus, which had a substantial effect on the supply side of the Hungarian economy. The permanent wage increase caused competitiveness of private firms to deteriorate. Such a decline in external competitiveness was mainly due to two (interrelated) factors: the political decision of a series of dramatic wage increases in both the public and the private sector; and the revaluation of the Hungarian currency, also motivated by political considerations. Starting with the latter, the deterioration of price competitiveness can be depicted most evidently by the changes measured in the real effective exchange rate (REER). Figure 6.8 clearly shows that between 1995 and 2000, REER remained steadily close to or below 100, but after that it climbed first to 109.8 per cent (2001) and then it reached 137.2 per cent by 2005, expressing a dramatic appreciation of the currency in real terms. Importantly, the erosion of price competitiveness is a natural consequence of the process of modernization and catching up.²² However, the extent, the dynamism and the timing of the appreciation of the Hungarian currency cannot be explained solely by economic factors—political motivations also had their own role.

The other main source of the decline in external competitiveness was the dramatic wage increases in both the public and the private sector. The economy-wide wage rise had basically two sources: the statutory minimum wage hike and the increase in public sector salaries.

i) Minimum wage

The statutory minimum wage was practically doubled in 2001 and 2002 by the conservative government. First, it was increased from

²² See especially Gáspár et al. (2003).

Figure 6.8 The REER and inflation

Source: EC (2005).

Remarks: the 2005 figures are predictions.

HUF 25,500 to 40,000 on 1 January 2001 and second, an additional rise followed in January 2002, setting the minimum at HUF 50,000. Consequently, the minimum wage rose by 65 per cent in real terms in two years. The ratio of the minimum wage to average gross salary jumped to an extremely high 43 per cent in 2002—which was in strong contrast with the previous level of 30 per cent or less that was characteristic after 1995. Moreover, the minimum wage became tax free in 2002, therefore the revenue side of the budget also suffered a substantial loss. Kertesi and Köllő (2004) found that the wage rise triggered a significant fall in employment opportunities, especially in the small- and medium-sized sector. They estimated a 3.5 per cent decrease of employment in companies employing 5–20 persons. The most seriously hit sectors were the labor-intensive ones, where the majority of the employees were unskilled laborers. Nevertheless, the authors emphasized that the main cause for deteriorated cost competitiveness was not simply the minimum wage hike, but its spilling over effect on the average salary, since employers needed to keep wage differentials alive.²³

²³ In 2005 the HSP–FIDA coalition decided to introduce a new minimum wage scheme program. The novelty of the scheme was the differentiated minimum wage, based on the level of education. Accordingly, workers without secondary education would get HUF 63,000 as the statutory minimum wage, while people who completed the secondary school would receive an extra ten per cent. An additional extra ten per cent would go to those with a diploma earned in a higher education institution. EIU (2005:26).

ii) Government wage bill

The public sector enjoyed a more robust increase in wages than what economy-wide average numbers depict. On average, employees in the public sector received a fifty per cent hike in total between 2001 and 2003. In concrete terms, in July 2001 civil servants and public order officers received a 35-55 per cent increase, which was followed by another increase in January 2002, now for army officers, too. The new socialist-liberal government continued the lax wage policy after the Spring elections of 2002. Public servants earned fifty per cent more after an autumn decision of the new cabinet, which was followed by another increase for civil servants and employees in the judiciary system. Altogether, public sector wage consumption increased by 23 per cent in 2002. A summary of events is given in Table 6.9. The number of public sector employees was also increased by 1.5 per cent in 2002 to 821,000.

Table 6.9 Wage increase in the public sector

Pay increase effective	Groups covered	Percentage increase
July 2001	civil servants, public order officers	35 to 55 for both groups
January 2002	public order officers, army officers	15 55
September 2002	public servants	50
July 2003	civil servants, employees in the judiciary system	15 25
November 2003	employees in the judiciary system	25

Source: OECD (2004a).

Remarks: data are in nominal terms.

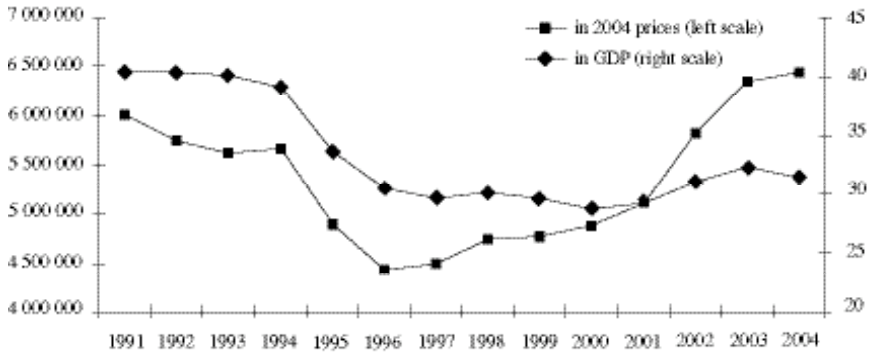
As it has been shown in section 4.3.2, the Maastricht process reevaluated the roles of the European labor markets and incomes policies significantly. Labor market adjustment and wage flexibility have remained the only devices in tackling permanent shocks, thereby attaching a greater than ever significance to the supply side. In turn, European countries strengthened the flexibilization of their labor markets significantly. The failed Hungarian wage policy, however, did not serve the

flexibilization of the labor market.²⁴ Instead, it eroded not just the competitiveness of the economy, but also reduced the hope for experiencing expansionary effects in times of fiscal contraction. More importantly, however, the failed wage policy did not simply result in a one-time pressure on the general budget. The tax-free minimum wages and increased public sector salaries meant a substantial future commitment in the budget (they can be best described as social rights) that can prove to be extremely hard to be taken back later.

6.3.2 Welfare spending

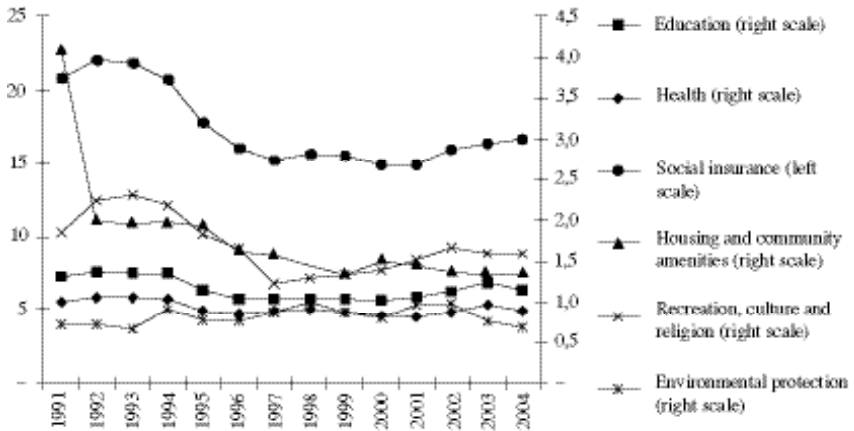
Besides wage consumption, welfare spending—the other politically sensitive group –, increased substantially in the last few years. Following the dramatic adjustment of 1995, welfare spending rose in real terms from 1997 onwards, albeit the drastic rise came in 2002 only (details are given in Figure 6.9). In 2002, welfare spending was increased by two percentage points in GDP, which was followed by an additional 1.2 percentage point rise next year. Figure 6.10 illustrates convincingly that the largest increase in spending (measured in GDP) was experienced in the spheres of social insurance, education and health care. Spending on education and health care went up by 1 per cent of the GDP throughout 2002 and 2003, while social security benefits rose by one and a half percentage points in the same period.

²⁴ See also Pula (2005) on this point. The author also claimed that despite of the fact that the Hungarian labor market was hit by a series of simultaneous shocks from 2001 onwards—such as the world-wide deceleration of economic activity, the change in the Hungarian exchange rate regime, the drastic increase of the minimal wage and the robust growth in public sector salaries—the rate of unemployment remained relatively unchanged, well-below the ratios of other CEE countries (6–7 per cent versus 12–20 per cent). Pula (2005) warns, however, that the constant ratio did not reflect a relatively flexible labor market. People who had to leave the manufacturing sector (approximately 60,000 employees) found new jobs in other segments of the economy, especially in the market service sector and the public sphere—sectors where nominal wages increased due to the artificial wage measures. The number of employed declined by 20,000 only, who, however, decided to leave the labor market, thereby increasing the number of inactives.

Figure 6.9 Welfare spending in relative and absolute numbers

Source: Finance Ministry (2005), ÁHIR data base.

Remark: welfare spending in 2004 prices is expressed in million HUF.

Figure 6.10 Functional decomposition of welfare spending

Source: Finance Ministry (2005), ÁHIR data base.

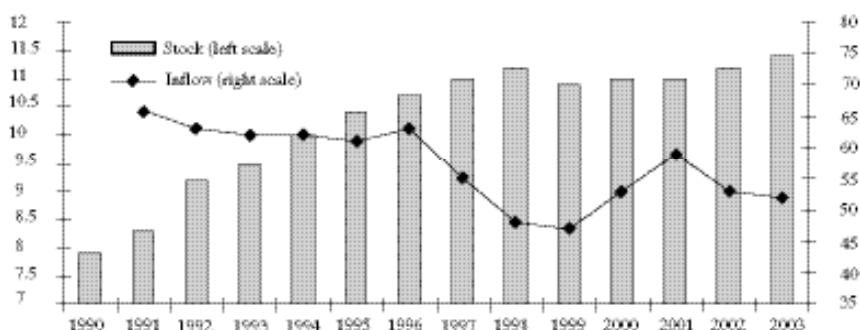
Remarks: ratios are in percentage of the GDP.

The generous welfare provision became one of the characteristic features of Hungary despite the fact that the share of employed citizens is incredibly low compared to other OECD countries, and the number of people who (is willing to) pay social security contribution to the state budget is even lower. Only four million out of the total seven million active people are registered employees in Hungary. OECD

(2005d) identified two main factors which could be responsible for the low employment ratio of the country (one of the lowest indeed among industrialized countries). First, the relatively high tax wedge on employment, which can reduce labor demand substantially and directs employment towards the black and grey economies. And second, the proliferation of strongly counterproductive measures provided by the welfare system itself: more than one-quarter of the working age population earn their living from social or labor market related transfers. As a corollary, a large number of the non-employed do not have an incentive to find a job. These disincentives are supplied through the generous household transfer system in practice, especially in the form of the disability benefit, sick pay and leave, and early retirement.²⁵

Hungary is one of those OECD countries where the share of *disability benefit* recipients and the amount of social benefit paid to them have increased drastically over the past decade. The number of benefit recipients increased from the starting level of 250,000 in the early nineties to 450,000 in 2004 which is more than 11 per cent of the total employees. An additional 350,000 people receive disability benefit, although they have already passed the retirement age. Disability benefit schemes pose a serious threat on the welfare system. In fact, non-employed people use disability benefit payments as a supplement for unemployment benefit schemes, since the unemployment benefit is paid for six months only, while there is no time limit for getting disability benefit. In total, 9 per cent of the population within the 20 to 64 age group is entitled to a disability benefit in Hungary, which is in strong contrast with that of other CEE countries or the neighboring Austria for instance, where the ratio is around 6 per cent only (OECD 2004a:76). The increasing inflow of disability beneficiaries has been depicted in Figure 6.11.

²⁵ Additional reason for the low activity rate is the relative capital intensive production of transnational companies in the country.

Figure 6.11 The number of recipients of disability benefits

Source: OECD (2005d:95).

Remarks: stock: per cent of total employees; inflow: in thousands of individuals.

Sick pay on the other hand is used by many as an extension of unemployment benefit after the termination of the employment contract. Employees are allowed to go on sick leave during their notice period, often actively supported by the employer. The total number of recipients of unemployment insurance benefit was around 100–130,000 in 2004, supplemented by an incredibly high 80,000 people receiving sick pay. Observing the high number of people on leave, the government decided to halve the eligibility period to three months in 2004, nevertheless, without deep structural reforms of the social security system, no permanent solution can be expected. Data on the number of beneficiaries are provided in Table 6.10.

Table 6.10 Number of recipients of some selected social protection schemes

Scheme	Number of recipients (2004)
Disability benefit	460,000
Early retirement	150,000
Unemployment benefit	100–130,000
Sick pay	80,000
Social assistance	110–125,000

Source: OECD (2005d:94).

Family benefits experienced a dramatic decline until 2000. However, the new millennium has brought a substantial change in this field

as well. Family-related benefits, such as transfer schemes and family tax reductions, contributed largely to the increase in households' transfers. In families with two children, the disposable income increased by 20 per cent in 2000 for instance, which was further increased later on. The most important transfer schemes are the following: family allowance (depending on the number of dependent children), maternity allowance, child-bearing benefit and childcare benefit (both comprise 180 days of insurance payments), childcare allowance (for three years), child raising support (for families with more than three children).²⁶

The highest amount of social security benefits are paid to pensioners. While *pensions* remained almost unchanged as a ratio of the GDP (around 9–10 per cent), their share in total social spending has increased substantially in the last few years. Due to the ageing population, neither the Bokros package nor the shift to the funded pension scheme could reduce the share of pension payment among social security spending (amounting to approximately 28–30 per cent of the total). Without further major reforms in the pension system, a skyrocketing increase in the implicit pension liabilities can be expected in the longer run, therefore. During the last year of the conservative government, the cabinet increased pensions well above the level prescribed by the statutory formula.²⁷ In fact, the government used an extensive part of the 2001 revenue windfall, due to the higher than planned inflation rate, to buy the votes of pensioners (the extra payments amounted to HUF 13bn). Over-spending was further aggravated by the introduction of a 13th month pension, following a socialist election campaign promise. Pensions paid to widows were also raised by 5 percentage points in 2002 (CP 2004a:18).

A serious problem in the Hungarian welfare system is the relatively large portion of people who choose to go on pension well before reaching the statutory retirement age of 62 years for men and 60 years for women. Two *early retirement schemes* enabled almost 90 per cent (!) of the employees to retire earlier. In the case of the advanced retirement pension scheme, without the loss of pension, after 38 active years, men are entitled to retire two years before the statutory retire-

²⁶ See especially OECD (2004a:77–78).

²⁷ The so-called Swiss formula is the following: $P(t) = 0,5CPI(t) + 0,5W(t)$, where $P(t)$ means the increase of pension in year t , CPI denotes the consumption price index and $W(t)$ refers to the change in the net average salary.

ment age, and women have a five-year ease. If people spend less than 38 years in work, they still have the option of early retirement under a second scheme, called the reduced retirement pension. However, these people have to face some reduction in their pension payment. With the explicit objective of reducing eligibility, the socialist-liberal cabinet proposed some amendments, however. Accordingly, the statutory retirement age will be increased to 62 years by 2009 for women, too; and the maximum possible length of early retirement will be set at three years for both sexes by 2009. Moreover, the required number of years that has to be spent in employment before having the option to choose the advanced retirement pension will be increased to 40 years (OECD 2004a and 2005d).

Besides social protection payments, health care expenditure experienced the most robust increase in welfare spending (recall Figure 6.10). Nevertheless, in spite of the increase, the health condition of the population is rather poor in Hungary. Life expectancy is among the lowest among OECD countries.²⁸ According to analysts, the Hungarian insurance-type health care system is strongly prodigal,²⁹ which can always rely on the bailing out of the central government in times of overspending (which have been rather the rule than the exception in the last ten years). The last year when the fund provided a sufficit was 1995 (0.2 per cent of the GDP). From 1996 onwards, the deficit became permanent. First, it climbed to 0.7 per cent in 1997 and 1998, then it was reduced to 0.5 per cent in 2000 and 0.2 per cent in 2001, but one year later it started to increase again and reached 1.7 per cent by 2003. The same rate was measured in 2004, too. (See especially OECD 2005d).³⁰

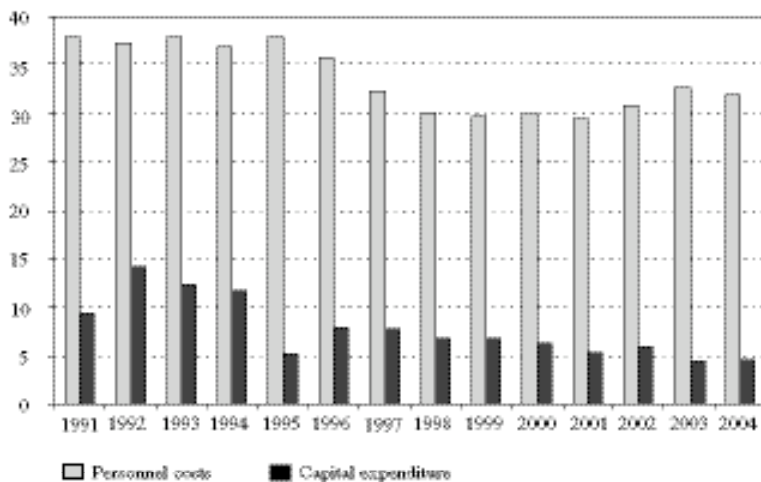
²⁸ Data are available in OECD (2005b).

²⁹ See Kornai and Eggleston (2001) and Mihályi (1999) among others.

³⁰ In Hungary, the National Health Insurance Fund is responsible for the purchase of health care services, using the contributions paid by both the employers and employees to cover expenditures. Its wide-scale autonomy, however, was considerably reduced in 1998 by abolishing the tripartite body responsible for allocating health expenditure. The collection of health insurance payments was shifted to the National Tax Authority in 2000 and its spending activities have been closely authorized by the Ministry of Finance. Although the budget is now prepared by the Ministry of Finance, the allocation is still made by the National Health Insurance Fund Administration (NHIFA) in practice. The NHIFA is responsible for purchasing the medical services and drugs from providers, using more than twenty sub-funds.

The decomposition of health expenditure into current and capital spending shows that replacement and new investment suffered serious blows in the last ten years, while wage expenditure could increase somewhat its share among the total health care spending following 2001, fitting well into the trend of general wage increase in the public sector (Figure 6.12).

Figure 6.12 Personnel and capital expenditure in the health care sector



Source: Finance Ministry (2005), ÁHIR data base.

Remarks: in percentage of the total health expenditure.

While the pension system has been partly restructured in the last few years, no similar attempt has been made in the healthcare system. The need for a comprehensive health care reform is an utmost necessity. The permanent overspending of the sector put severe pressures on the general government, being one of the main causes for the deficit bias. The deteriorated performance of the sector is mainly due to the overspending of the so-called pharmaceutical sub-fund, which accounts for almost one-third (!) of the total spending of the health care sector, an extremely high and biased ratio in any comparison, which puts Hungary in the second place after France in Europe in this respect.³¹

³¹ Countries with the same level of development as Hungary spend around 10 to 15 per cent of health care expenditures on drugs.

The outstandingly high ratio poses a permanent challenge for alternating governments.³²

It is worth underlining again that the negative tendencies in welfare spending do not reflect temporary deficiencies only; instead they refer to substantial *structural problems*. The proliferating examples of increased family allowances or the relatively high and rising number of disability benefits and sick pays, the incredibly high share of people with early retirement schemes prove that citizens consider such benefits as entitlements which are simply not part of the annual budgeting debate. Once people have been entitled to receive these allowances and benefits, they are hardly willing to give up them, and show strong political resistance. Just like in the case of the failed wage policy, welfare spending can be regarded as a future commitment in the general budget that is extremely hard to correct later on.

6.4 Struggle without hope

The serious deterioration in public finances was of course recognized by the government as well. The first attempts to stop overspendings were initiated in June 2003, with the aim of saving 0.4 per cent of the GDP. The most important steps were said to be the restriction on housing subsidies and the freezing of 2.5 per cent of the expenditure appropriations of the central budgetary institutions. Nevertheless, these efforts proved to be hardly sufficient to revert the deteriorating tendencies in the general budget (CP 2004a:18). Housing subsidies instead added a 0.3 per cent of GDP increase to the end-year deficit in 2003, mainly due to the accelerating demand for interest subsidies on mort-

³² The permanent overspending of the drug fund induced the government to initiate an across-the-board price cut of 15 per cent on 1 April 2004, as part of the austerity measures of the Draskovics package (see more below). Since the extraordinary price intervention was allowed to be implemented for 180 days only, according to the Hungarian legislation on price regulations, the parliament authorized the government to gain a full price-setting power over pharmaceuticals from 1 January 2005. The amendments were inevitable because drug subsidies exceeded the budgeted targets by around 16 per cent in 2003 (EIU 2004). Accordingly, the government introduced spending caps on pharmaceuticals of HUF 270bn, 285bn and 296bn for 2004, 2005 and 2006, respectively. If these limits are exceeded, the level of state subsidy is reduced accordingly (each HUF 3bn excession triggers a 10 per cent reduction in state subsidies) (OECD 2005d).

gage loans. Additionally, the unfavorable financial market reactions to the lax fiscal policy and the failed exchange rate policy forced the central bank to increase its benchmark interest rate (providing the highest real rate in CEE), thereby increasing the debt burden as well. The Hungarian Finance Ministry estimated the increase in accrual-based net interest expenditures at 0.3 per cent of the GDP (*ibid.* 16–17).

In early 2004, the so-called Draskovics package was launched in order to achieve a 1 per cent savings in the general budget. The most important adjustment step was a reduction in the staff of the central public administration by 7000. Although the reduction did not amount to huge savings (estimated to be around HUF 10bn), it was meant to signal the commitment of the cabinet to fulfill its targets laid down in the convergence program. An attempt was also made in order to reduce personnel in local governments by limiting financial sources provided by the central government for wage increases—local authorities employ around 520,000 individuals of the total 800,000 (EIU (2004:29).

The Draskovics package intended basically to reduce the operational spending of ministries (inclusive of spending on maintenance, renovation, IT, etc.) and of ministry-funded institutions and the politically least sensitive part of the budget, public investment (except for EU-related projects).³³ A serious revision of the housing subsidy scheme was initiated, too. Expenditure control was enforced in the social security system, focusing especially on the costs of hospitals and pharmaceuticals. Conditions were tightened for the use of unspent appropriations from previous years. An ad hoc fund was created where ministries had to pay in their savings. Using unspent appropriations was only possible with the approval of the finance ministry. Local governments and extra-budgetary funds faced spending ceilings also in order to fulfill a balanced budget by August 2004. Some one-off measures were introduced as well in order to (i) collect dividends from SOEs

³³ According to the Convergence Program (2004a), the original aim was the following: “[A]pproximately 50–50 per cent of the savings measures relate to current and capital expenditures, respectively. Altogether they improve the balance of the general government by nearly 1 per cent of GDP. The savings must be achieved in chapter-administered appropriations, in government investment projects and in institutional expenditures. In addition, more than 100 foundations, public foundations and non-profit companies operated from budget funds will be terminated” (*ibid.*19).

(August); and (ii) to freeze the reimbursement of VAT refunds—a highly controversial action (OECD 2005d:53).

Despite the apparently firm plans of the cabinet, the primary accounts showed further imbalances. Housing grants witnessed again a significant 0.4 per cent slippage of the GDP at the end of the year. Although wage increase was stopped successfully in 2004, the non-wage expenditures of line ministries accounted to a 0.9 per cent of GDP overspending instead. As a response, wage consumption was deliberately restrained in the central government (e.g. the payment of the 13th month public salary was shifted from December to January).³⁴ Additionally, social security funds provided a higher than expected deficit by 0.4 per cent of the GDP (on a cash basis) and the higher than expected interest rates contributed significantly to larger interest payments by 0.6 percentage points, too (OECD 2005d:54).

2005 experienced some minor attempts to consolidate the general government. The corrective measures were adopted in two subsequent steps. First, following the Council's opinion on the December 2004 updates of the convergence program, the government decided to adopt an across-the-board spending cut, thereby increasing the emergency reserve package by 0.3 percentage points of the GDP. Revenues also increased by a 0.1 percentage point. In June, another round followed, by increasing the gambling tax and widening the base of social security. These steps were supplemented by some expenditure side actions as well: the freezing of expenditures (0.6 per cent of the GDP) which were then set aside in the emergency reserve fund; and ministries were also obliged to reside from spending their whole budget appropriation, thereby accumulating residuals. Nevertheless, these corrective measures were not enough to prevent the deficit to rise. In September 2005, the Hungarian government admitted that the original target of 3.6 per cent (laid down in the December 2004 convergence program) was highly optimistic and confirmed the new target of 6.1 per cent.³⁵

³⁴ Later on, however, the European Commission decided in its notification on excessive deficit that the 13th month salary of government employees had to be kept in the books of 2004.

³⁵ The change was basically due to the decision of the European Commission regarding accounting standards. Originally, the Hungarian government planned to sell motorways to the state-owned motorway construction corporation (ÁAK Rt) and the 1.9 per cent of GDP revenues were hoped to

In sum, the corrective measures, following the substantial overspending in 2001, 2002 and partly in 2003, were ad hoc in style and proved to be insufficient to revert the unhealthy tendencies in the economy. The reduction in deficit proved to bring about temporary results only, resembling rather creative accounting than anything else. Csaba (2005a:193) claims accordingly that “[c]reative accounting is well and alive, thus the true size, and what is more important, *the actual pattern of public spending* becomes known only ex post facto. This is a danger, since it may become quite hard to develop *rational expectations* concerning any macroeconomic variable and their prospective development trajectory.” Such measures do not facilitate the emergence of non-Keynesian effects for sure because expansionary fiscal consolidation is strongly conditioned on real and robust spending cuts in the politically most sensitive items of the general budget, as it was shown in Chapter 4.

6.5 Summary

Chapter 4 concluded that the composition of fiscal adjustment directly affects the likelihood of success and that of the macroeconomic consequences, especially economic growth. It also tried to demonstrate that successful fiscal consolidation can be attained only if the government is willing to take on the cuts of the politically most sensitive items of the budget, such as social transfers and the public sector wage bill, elements that are most inclined to grow automatically. Accordingly, this chapter applied a disaggregate view, with the explicit aim of identifying those elements of the general government which caused the serious deterioration in fiscal performance in the last few years in Hungary.

Our analysis found that even from a bird’s eye view, the *size of the state* is much above the level of development of the country. The redistribution rate is around 50 per cent of the GDP, which is approximately 10 percentage points above the CEE-8 average and exceeds even the EU-15 average, reaching the redistribution level of Austria and Belgium, countries with a two times higher per capita GDP on purchasing

finance the deficit. Fiscal position was further weakened by 0.1 per cent of the GDP due to the 13th month salary (as it happened one year before as well). Moreover, VAT revenues were less than predicted—the gap amounted to around 0.25 per cent of the GDP (CP 2005).

power parity. Certainly, a high redistribution ratio should not necessarily bring about irresponsible fiscal policy, but the relatively large redistribution can make a country more vulnerable to external shocks.

In Hungary, the high rate of redistribution is paired with a permanent *fiscal deficit* much above the Maastricht reference value of 3 per cent. Overspending has been the highest in the European Union in the last couple of years, which reflects a lack of responsibility in conducting public finances. The general government deficit is mainly due to the overruns in the primary balance, especially in current spending, that is, as opposed to the political rhetoric of alternating governments, the extra spending is not assigned to capital expenditures, but serves short-term political interests. Moreover, the huge Hungarian deficit has definitely not been cyclical; it reflects *structural deficiencies* of the general budget. Nevertheless, the relatively large size of the state should not necessarily bring about a huge and permanent deficit. Fiscal discipline can be practiced even in countries with large redistribution rates. The classical European examples of the welfare state, such as Sweden, Denmark or Finland, run a state budget of over 50 per cent of their GDP, yet they are still able to avoid the violation of the Maastricht criteria and moreover these are the countries where economic growth is much above the EU-15 average. The Nordic countries, however, as opposed to Germany or France for instance, were able to implement serious structural reforms on the spending and revenue side of the budget in the last decade, during the Maastricht years. Unfortunately, in Hungary, it is feared that the too large degree of redistribution, along with the permanent and huge deficit, undermines a sustainable and long-term economic growth.

By reviewing the *composition* of the budget, it has been revealed that over-employment became a serious problem in the public sector. Approximately one-fourth of the total employees work in the public sector, illustrating convincingly that the state administration might be lacking in efficiency. Although the state provides labor opportunity for (too) many, still, the labor force participation ratio is the lowest among OECD countries, much below 60 per cent, in contrast to the Nordic welfare states, where the rate is above 70 per cent. The *wage policy*, conducted in the last few years, made state employment appealing for people, thereby devaluating the attractiveness of the private sector for potential workers. The failed incomes policy put a pressure on the

competitiveness of the Hungarian economy as well. Wage outflow generated an increased aggregate demand and induced the import to increase and the external balance to deteriorate accordingly.

Transfers to households have also been increased substantially. The structure of welfare spending suffers from serious distortions. Spending on health care and education is still lower than in the EU-15. On the other hand, sick pay, disability pay and early retirement schemes are much more generous, being disincentives to employment. The disincentive structure of social protection makes non-participation in the labor market appealing. Subsidies on pharmaceuticals or housing also contributed to the deteriorated fiscal performance. Interestingly, economic functions conducted by the state often serve the interest of households, therefore price regulations or subsidies can be considered as welfare benefits as well.

Importantly, the failed wage policy and the generous welfare provisions exercised in the last couple of years by the alternating governments did not simply result in a one-time pressure on the general budget. The tax-free minimum wages and increased public sector salaries mean a substantial future commitment in the budget that can prove to be extremely hard to be taken back later on. Also, the proliferating examples of increased family allowances or the relatively high and rising number of disability benefits and sick pays, the incredibly high share of people with early retirement schemes prove that citizens consider such benefits as *entitlements* which are simply not part of the annual budgeting debate. Once people have been entitled to receive them, they show strong political resistance if the government tries to reduce or eliminate any of these.

Besides the drastic cutback of the financing need of the state, one of the most significant results of the Bokros package in 1995 was the reduction of gross *debt*. By 1999, the debt-to-GDP ratio was brought down to the Maastricht reference value of 60 per cent. Following 2001, however, the ratio has started to rise again, although the sustainable level of the Hungarian debt would be around 40 per cent of the GDP.³⁶ Moreover, the role of foreigners in financing gross debt has increased significantly in the last few years, causing an increase in the price of borrowing.

³⁶ See especially the estimates of Orbán and Szapáry (2004).

Although this chapter does not focus on the *subsystems* of the general government, it is worth mentioning that without a comprehensive reform of the health care system, education, the public administration and local governments, no real breakthrough can be expected regarding efficiency and fiscal performance. Yet, the remedy of these structural deficiencies demands a complex set of reform measures, well beyond the scope of any short-term fiscal stabilization, and can entail significant costs which may even worsen the fiscal balance temporarily.

CHAPTER 7

Labor Market Structure and Wage Bargaining in Hungary

The (Ir)relevance of a Social Pact

The decompositional analysis of Chapter 6 has documented that the deterioration of fiscal performance after 2000 can be traced back basically to two politically sensitive items of the general government: the public sector wage bill and household transfers. In Chapter 4, it has been shown that without the reduction of these two items, there is hardly any real chance for the occurrence of non-Keynesian effects in principle. Although the cutback of politically sensitive items can be rational from a purely economic point of view, it may be highly unrealistic from a political perspective. As we have seen in Chapter 4, the *political willingness* of governments to reduce these specific elements of the budget is heavily conditioned on both the structure of the labor market and the support of social partners.

In the following it will be shown that the labor market in Hungary is already relatively highly deregulated and wage negotiation is decentralized enough to facilitate in principle the emergence of non-Keynesian effects. However, it will also be argued that the current political (power) and economic constellation in Hungary is not suitable for the introduction and consolidation of a *social pact*. In the vein of the numerous, highly constructive examples of the old member states of the European Union, a strengthened partnership and the revitalization of social pacts are not the way forward in order to achieve fiscal reform and the euro adoption in Hungary.¹

In this chapter, a comprehensive description of the development of Hungarian industrial relations will follow by applying a historical and

¹ It is worth recalling once again that a decentralized labor market structure and a more strengthened national coordination mechanism are not in contradiction with each other, as it has been documented in section 4.3.

analytical perspective. First, the evolution of industrial relations in Hungary will be documented. Next, in section 7.2 an analysis of state-, sectoral and firm-level negotiations will be offered. Section 7.3 raises the issue of the irrelevance of social pacts; and section 7.4 concludes.

7.1 The evolution of industrial relations in Hungary:

A historical overview

There is a widely shared consensus in the international literature of industrial relations that the representation of labor's interest is terribly weak and even the existing system of employment relations is highly fragmented in Central and Eastern Europe. The weak and polarized structure of social partnership gave birth to a relatively underdeveloped collective bargaining system in transition economies. Interestingly (but not without reasons), in CEE the institutionalization of social dialog had been manifested almost exclusively in the form of the tripartite national bodies in the early years of transformation. In Western Europe, on the contrary, the sectoral level became the main forum for interest reconciliation, which has been supplemented by national tripartite negotiations, often in the form of social pacts—especially in the nineties.

The establishment of formal tripartism at the start of the Central and Eastern European transformation has been a result of specific circumstances. The newly elected governments were in need of the support of social partners who could cushion the social consequences of the reform and moreover who were able to legitimize the drastic measures of stabilization and restructuring. Sharing the responsibility was a major motivation for governments to involve social partners at a national level in economic policy—although usually as a consultative body only. In exchange, the newly formed governments did not establish representativity criteria for trade union and employer organizations: independently of the membership size, interest organizations were invited to tripartite national councils in order to broaden the consent on economic reform as much as possible.

The very first tripartite body in CEE, the National Interest Reconciliation Council (NIRC), was established in Hungary in 1988, with the explicit aim of determining the guaranteed minimal wages and preparing the guidelines for the minimum and maximum increase of wages. In other countries of the region, interest reconciliation councils

did not have too much say either in employment relations. The first democratically elected Hungarian government inherited the NIRC and because of its evident links with the former communist rule the conservative cabinet restructured significantly the council, inviting several organizations that comprised both employees and employers. The legal and structural framework of the council was codified by the Employment Act (1991) and by the Code of Labor (1992). The latter suspended central wage regulation from 1 January 1993, the role of which was overtaken by the labor market on the one hand and collective agreements on the other hand. Furthermore, specialized committees had been set up: the Labor Market Committee—which had the authority of deciding on the use of the financial sources of the Employment Fund—the Training Committee and the regional committees of the NIRC.

In established democracies, the main aim of social partnership is basically the establishing of harmony among divergent interests with the active cooperation of employers and employees. There, in the social dialog, the state remains quite often in the background only or acts as an equal partner in the negotiations. In Hungary, however, it was the government which exercised the most powerful influence in interest reconciliation. The main object of tripartism in the region was therefore *reconciliation*, a term that was characterized by Ladó (1996) as more than just listening to the views but still far from making decisions (or giving consent). It was a forum where views were expressed, consulted and possibly harmonized. Héthy (1993) distinguished three challenges that tripartism should have faced in the region: (1) active participation in the shaping of the institutional and legal structures of industrial relations as a minimum task; (2) cooperation with the government in certain fields of economic policy (especially in incomes, employment and social policy); (3) remedying social conflicts. Tripartism and the inclusion of social partners, however, was reduced to the first task only in the region and there was not much evidence for going beyond that. Social partners were usually left out from economic policy-making and were welcomed only in the implementation phase. Accordingly, social partners had no say in strategic issues, only marginal topics were delegated to them (such as minimum wage agreements); and the time-span of decisions was dominantly short term such as the tripartite control of the annual budget for instance (Héthy 1993).

One of the special features of Hungarian interest reconciliation was the large number of participants and the high degree of heterogeneity

of organizations. In spite of the large number of interest organizations, the former official trade union remained the most influential entity.² The division line between the old union and the new labor movements proved to be unsurpassable, a phenomenon widely observed in transition countries.³ Nevertheless, an agreement on a social pact was almost achieved under the second freely elected government led by the Hungarian Socialist Party in 1994 (in accordance with the party's election promise). However, the adoption of a comprehensive pact was never realized, due to the launch of the necessary austerity measures in March 1995. The program of fiscal consolidation was prepared without the involvement of interest groups.⁴ As a corollary, social partners became disappointed, and the government gave up its initial idea of adopting a social pact. Nevertheless, the IRC existed formally until 1998, when the new cabinet, under the right-wing Fidesz, suspended the tripartite bodies of pension and health insurance. In turn, social dialog had been "decentralized" in the form of bipartite negotiations at a local level, while the government brought all decisions with national importance under its own jurisdiction. An Economic Council was established with the function of consultation on economic issues, such as privatization or budgeting. The European Commission (2002) emphasized that the changes were initiated without the involvement of the social partners, implementing the exclusive decisions of the government. However, social dialog recommenced in July 2002, due to increasing pressure from the EU and the socialist-liberal coalition that came back into power.

It is worth emphasizing that macroeconomic stabilization, necessary at the beginning of the transition, provided a relatively small leeway for the governments of the region to consider and respect employee interests in the years of transformation recession. As a consequence,

² Originally, seven confederations came into being at the time of the transformation, which very quickly dropped to six. Nevertheless, only three of them, the MSZOSZ, the Liga and the Munkástanácsok played a major role in interest reconciliation.

³ Accordingly, Ladó (2002) comments that the self-identification of labor organizations is highly manifested in their relationship to the past: either they build on it or they completely deny it.

⁴ In fact this was the first (and only) year until now when the IRC did not agree on the minimum and maximum wage increase.

the protection of interests dropped in importance, thereby devaluating the role of employees' organizations. They lost their credibility among the employees before they had the chance to grow strong and put down roots in spite of the unfavorable heritage. Yet, Iankova and Turner (2004:78) insisted that the establishment and consolidation of tripartism proved to be the means by which social peace could be preserved during the political-economic transformation of the region. In making a peaceful transition possible, the early establishment of National Interest Reconciliation Committees played a significant role.

Nevertheless, elsewhere Iankova (2002:11) also admits that in vein of the decade-long transition, the tripartite structures in the region do not resemble their Western counterparts. While in continental Europe for instance social dialog focuses on wage negotiations, different kinds of social benefits and agreements, or even general issues of the national economy, in CEE countries the forums for social dialogs are strongly imbued with everyday party politics and it is rare for social partners to concentrate on labor issues exclusively. Martin and Cristesu-Martin (2003) therefore argued that it was the intimate relationship of organized labor and politics which made it possible to provide institutional protection for unions. This was highly the case in the revisions of the Labor Code in 2002, enacted under pressure from the EU in the region. In Hungary, for example, the socialist-liberal government reconstructed the whole employment system in favor of employees after the general elections of 2002, which in turn revitalized tripartism in the country. Nevertheless, political proximity came with a high price: labor institutions fell under a strong political influence, and consequently the change in political power could have had a serious effect on employment relations, too.

As far as the most recent developments are concerned, the European Commission (2004:169) is rather sceptical with respect to the consolidation of tripartism in the region. Generally speaking, while social dialog had been primarily (and almost exclusively) initiated via tripartism in CEE, it proved to be a rather short-lived attempt in several cases. The mid and late nineties witnessed a strong decline in the interest of governments in strengthening further social dialog at a national level. Although governments sought the explicit support of social partners in the early years of transformation in order to get consent on implementing harmful reforms, later the intensity of relationship weakened significantly. In fact, only the early years of the change could provide

some real social pacts in the region, such as the social peace agreements in Bulgaria, the general social pacts and annual wage agreements in Slovakia or the social pacts in Poland. The experience of social partnership is just the opposite of what Western Europe produced in the last decade, where the Maastricht process revitalized enormously the social dialog throughout the whole decade.

Nevertheless, the new millennium has brought some changes within the process of EU accession. The EC's (2004) report on industrial relations names only four countries in the region where tripartism has survived, and these are Hungary, Slovakia, Slovenia and Estonia. According to the report, the new agreements go beyond the sphere of labor and wage, focusing on issues such as immigration and EU accession and membership (or in Hungary and in Estonia the ILO matters). Yet, it is worth noting that these attempts are more formal than the earlier ones and are initiated almost exclusively by the state and follow the strategy of the governments.

7.2 Labor market implications of the enlargement:

The three levels of social (non)dialog

The aim of tripartism is the strengthening of industrial relations and the maintaining of social peace. In most of the successful old EU states, tripartism played a substantial role in establishing a public consensus; thereby facilitating the implementation of economic reforms. Consequently, the EU required the accession countries to reinforce social partnership, which in turn reevaluated the role of their labor organizations. Nevertheless, by and large, the state has remained in the heart of employment relations, while the employers' side still suffered from serious under-organization. The fragmentation of employees' associations did not help either in meeting fully the EU's desire for revitalizing the social dialog effectively.

7.2.1 The pivotal role of the state

State involvement in employment relations, especially in the regulation of labor market has remained significantly strong in CEE countries. Even at the level of firms, the state tried to intervene in labor matters extensively. In spite of the fact that organized labor is, in general, relatively weak and fragmented in CEE countries, employment

protection legislation is rather well-advanced. Regulation on working time, health, safety or collective dismissals are usually legally binding for companies. Although countries such as Austria, Germany, the Netherlands or Italy perform much better than Hungary on average regarding the strictness of employment protection legislation, the indicators for CEE countries are not worse than those of Ireland and Denmark—not mentioning the UK (see Table 7.1).

Table 7.1 The summary indicator of the strictness of employment protection legislation in selected countries

	Protection of permanent workers against dismissal (1)	Specific requirements for collective dismissal (2)	Regulation on temporary forms of employment (3)	Summary index (1)+(2)+(3)
Hungary	0.8	0.5	0.4	1.7
Czech Republic	1.3	0.4	0.2	1.9
Poland	0.9	1.2	1.0	2.1
Ireland	0.7	0.4	0.2	1.3
Netherlands	1.3	0.5	0.5	2.3
UK	0.5	0.4	0.2	1.1

Source: OECD (2004b:72).

Remarks: data as of 2003. The scale for each variable is between 0 and 2. The higher the mark, the stricter the employment protection.

The central role of the state in the formulation of employment relations in CEE is not accidental. Paradoxically, one of the main challenges of the whole transformation process was to withdraw the state from different subsystems of society, following the triumph of the trinity of stabilization, liberalization and privatization. Consequently, the state's role should have been reduced to an equal of the social partners. Exactly the opposite happened in the field of employment relations. The apparently "unexpected" result of transformation in the field of industrial relations reflects the fact that without the state (and its administration and capacity), the establishment of new institutions, procedures, the consolidation of new norms, behavioral patterns, etc. would have been almost impossible (see Csaba 2002). Only the state possessed the capacity that was required for changing the patterns in labor markets at the time of the EU accession. In order to finish har-

monization successfully, the interest of Brussels was evidently the strengthening of the state administration instead of supporting social partners more explicitly.

The power-relationship between the state administration on the one hand and labor organizations on the other hand deteriorated further. Labor organizations were subordinated to state authority, making interest organizations more vulnerable to changes in state/government politics. The state did not simply set up the legal and institutional framework in industrial relations but also created or appointed and invited social partners to the table of discussions where only the government had the right to define the agenda. One logical consequence of the EU pressure in adopting European labor structures was the strengthening of the state vis-à-vis the unions in an unjustified extent and consequently and contrary to its initial aims, the EU helped in further politicizing the employment relations.⁵

The relative strengthening of the state vis-à-vis the social partners, therefore, can be explained by several factors in the region, including Hungary:

- (i) weak and fragmented unions;
- (ii) too strong dependence of social partners on the financial and technical assistance of state administration;
- (iii) low and declining density and lack of trust in unions (unionism considered as a ghost from the past);
- (iv) missing sectoral level negotiations; and
- (v) explicit support to the state (and the national level negotiations) from the EU.

7.2.2 Sectoral-level collective bargaining: The weakest chain

In the EU, social dialog at the sectoral level is highly significant (if not the most significant). In CEE, sectoral-level collective bargaining has remained extremely underdeveloped. This is not surprising, since the

⁵ Martin and Cristesu-Martin (2004:633) wrote accordingly: “The independent ‘value-added’ contributed by tripartism was thus limited. When governments sought to limit the agendas or to ignore the decisions of tripartite institutions there was little effective opposition.”

functioning of a strong and developed interest representation requires that sectoral-level collective bargaining has a substantial say in governmental economic policy decisions. In the coordinated systems of Western Europe, the veto on economic policy is not that rare. It is also important that organized labor is capable of successfully organizing its membership. Several factors pushed CEE countries into a different direction. Sectoral level agreements were entirely missing under the communist era. Following the change, the large number of small companies and their dynamic growth has not favored sectoral agreements either. Moreover, the diverse structure of enterprises (with many foreign owners) within the same industry makes it extremely difficult (and costly) to negotiate.

Relative irrelevance of sectoral bargaining is reflected in the low number of collective agreements—showing an overall declining trend⁶—which is further aggravated by the missing legal frameworks of institutionalized sectoral level negotiations. In fact, in CEE the labor code is generally silent on the sectoral level, instead it specifies “multi-employer” or “higher-level” agreements. Furthermore, collective agreements are signed mostly at the enterprise level, instead of the sectoral level.⁷

While there is a general tendency in continental Europe for trade union density to decline, the coverage has remained stable in the last twenty years: negotiated conditions have been extended to almost two-thirds of the workers.⁸ In spite of some attempts to revive sectoral agreements in CEE, especially under pressure from the European Union, they have remained relatively rare. Their significance in wage and working conditions negotiations is almost negligible in some countries (coverage is spread between 8 and 40 per cent only). Nevertheless, the existing sectoral level collective agreements in CEE are usually just the reproductions of national-level agreements. Generally speaking, the provision of sectoral-level agreements are not more than minimum

⁶ The Hungarian numbers on collective agreements were the following: 24 in 1992 and 14 six years later.

⁷ See European Commission (2002).

⁸ Union density measures membership size, while collective bargaining coverage reflects the share of laborers who are subject to union-negotiated terms and conditions of employment. The two measures should not necessarily coincide with each other, as documented by Table 7.2.

Table 7.2 Trade union density and collective bargaining coverage in selected countries

	Trade union density, 1990	Trade union density, 2000	Collective bargaining coverage, 1990	Collective bargaining coverage, 2000
Hungary	63	20	n.a.	30+
Czech Republic	46	27	n.a.	25+
Poland	33	15	n.a.	40+
Ireland	51	38	n.a.	n.a.
Netherlands	25	23	70+	80+
UK	39	31	40+	30+

Source: OECD (2004b:145).

Remarks: data are expressed in percentage. Figures with a + sign represent lower-bound estimates.

standards, quite often reduced to a simple minimum wage agreement. The relative insignificance of this level prevents collective agreements to be more comprehensive, therefore, participation in production-related matters is usually missing completely. Tendencies in trade union density and sectoral-level collective bargaining coverage are shown in Table 7.2.

7.2.3 At the lower end of the spectrum:

Company-level negotiations

The development of enterprise-level bargaining was determined by the process of privatization and the appearance of multinational companies. Privatization, in fact, was not simply a means of restructuring the economy and transferring ownership from state property to private property, but was also a key determinant in reshaping employment relations. Contrary to the expectations of the EU, privatization did not result in the rebirth of an institutionalized (continental European) sectoral-level collective bargaining regime, instead it intensified enterprise-level negotiations and shifted labor market extensively towards deregulation. Nevertheless, privatization *per se* may not trigger a significant restructuring of the employment relations. The method of privatization proved to be essential in articulating labor interests. Management buy-

outs shifted power into the hands of managers while employee-owner-ship schemes strengthened the workers' position.⁹

While privatization does not necessarily restructure employment relations entirely, foreign direct investment (quite often in the form of green-field investments) brings about a totally new re-institutionalization of industrial relations. In fact, the driving force behind the relative strengthening of the workplace-level negotiations as opposed to the sectoral-level collective bargaining has been the opening up of economies to FDI. As compared to other countries in the region, greenfield investments have been more characteristic in Hungary, from which the country benefited relatively early on. On the one hand, greenfield investments are naturally closely associated with a relatively low level of unionization. On the other hand, these investments brought not only managerial skills, know-how and production technology but also new human resources management techniques and employment relations' design. Great degree of diversity of employment relations in foreign companies created a huge degree of variation in the system of company-level bargaining.¹⁰

For sure, in pluralist systems such as the UK or the USA, the trend of divergence is easily acceptable, but in neo-corporatist regimes it is not without doubts. In fact, whatever the EU wanted to achieve in principle in employment relations in postsocialist countries, it was ultimately the private sector, dominated by foreign-owned companies, that determined labor-employer relations in practice.

As it has been discussed in some length in section 4.4, companies in Western Europe were strongly interested in agreeing on pay and

⁹ Among others, Aguilera and Dabu (2005) interpreted these insider-dominated privatization strategies as the survival of the past. The authors emphasized that privatization opened up the door to global competition well before the corporatist institutions could have been developed and consolidated.

¹⁰ Meardi et al. (2005), on the other hand, claimed in their comparative case studies on the automotive sector of three CEE economies (Poland, Hungary and Slovenia) that these countries can be best described as hybrid regimes where neither pure Americanization nor a pure collectivist, German-type model has emerged, instead "the dynamic situation of power balances modifies in different ways American and German influences, encouraging often innovative solutions" (ibid. 11).

working conditions in the form of social pacts in order to enhance the competitiveness on the world market. The resurgence of neocorporatism was possible because of the mutual interest in dynamizing the supply side of the economies. Employers therefore drove the system into an organized decentralization—with the consent of employees (Traxler 1995). Essentially, a social pact is a kind of *competitive macroconcertation*: a forum where state and the social partners meet regularly in order to negotiate about policies such as wage and other social and fiscal issues which are otherwise segregated formally. Such a consent, however, was not needed at all in the former socialist countries, since the unorganized, cheap and skilled labor made it simply unnecessary. Multinationals moved into the region exactly because they saw no threats to competitiveness, therefore there was no reason to take a seat at the negotiations. Moreover, the new employers—especially the large multinational corporations—were able to negotiate with the state face to face. The strong bargaining position of employers enabled them to gain benefits which ensured the maintenance of their competitiveness and their ability to internalize major shocks due to their economies of scale. In short, the appearance of foreign-owned companies on the one hand and the lack of strong sectoral industrial relations on the other hand moved the employment relations system evidently towards a deregulated system of enterprise-level negotiations.

The detailed overview of the three levels of negotiations practiced by the new member states illustrated clearly the *lack* of those neocorporatist structures which made it possible to revitalize employment relations in the form of social pacts in some small and open Western European countries in the last decade. The accession negotiations and the adoption of the *social acquis* partly re-institutionalized social dialog in the region, but this has not brought to the evolvment and consolidation of some kind of tripartism.¹¹ It is not an exaggeration to claim therefore that there is no convergence towards the continental neocorporatist structures—the ones that are often labeled as “organized decentralization”. It would be difficult to better formulate the hopelessness of the development of corporatist structures in the new members than that provided by Hyman and Frege (2002:5–6):

¹¹ A highly critical assessment of Central European tripartism can be found in Ost (2000) for instance.

There is enough evidence now to suggest that despite positive signals from the recovering economies, the re-institutionalization of new industrial relations has not succeeded. Tripartite committees often exist as pure window-dressing; the extensive labor legislation is frequently not implemented as the policy-makers (presumably) planned; unions are declining all over Central Eastern Europe and have a hard time modernizing, especially in the private sector; greenfield sites are usually non-unionized; collective bargaining is still relatively rarely institutionalized at the sectoral or workplace level; and working conditions are deteriorating, with workers seemingly unable to defend their interests in their postcommunist societies.

7.3 About the irrelevance of a Hungarian social pact

The current member states of the euro-zone spent the bulk of the nineties with implementing wide-scale and often burdensome reforms of the general government. Their fundamental aim was to fulfill the fiscal convergence criteria of the Maastricht Treaty, which was later strengthened by the Stability and Growth Pact. Fiscal tightening evolved in most of these countries with the consent of the majority of society. The means to this end was the establishment and consolidation of social partnership and the revitalization of social pacts in several countries. Ireland and the Netherlands count as classic examples by now, but Belgium, Austria, Portugal and to some extent Italy provide plausible cases, too, where the government and the social partners could agree on the design of fiscal retrenchment. In Hungary, however, even the outlines of such an agreement are not in the least visible.

Admittedly, there is agreement among politicians and the professionals alike that the creation of a social pact with a firm and comprehensive legitimacy could support the achievement of the reference criteria enormously, and could also establish the ground for long-lasting and balanced growth. Bruszt, Oblath and Tóth (2003) for instance are on the following opinion: “the medium term agreement of the social partners on economic policy would improve considerably the conditions of the establishment and the maintenance of a sustainable economic growth.” Laki (2003) favored the Dutch social agreement as a means for achieving consensus on the initiation of fundamental reforms and considered it to be the model that Hungary could follow. Similarly to these authors, influential think-tanks, research institutions and even the central bank and the finance ministry advocated a medium-term agree-

ment between the social partners and the government in order to facilitate fiscal reform, and as a corollary the swift change over to the euro.¹²

While the initiation of a social pact in Hungary or any other CEE countries seems to be desirable, especially at the time of changing over to the single currency, it is highly unlikely that these countries can adopt an effectively working social pact. Several reasons have been discussed already above, such as:

- (i) strong state *versus* weak and often fragmented interest organizations—the non-existence of tripartism;
- (ii) the (almost perfect) lack of sectoral level collective bargaining; and
- (iii) the lack of interest of employers in a strengthened system of wage (and non-wage) negotiations.

Further arguments can be added to this list in providing evidence against the viability of a social pact. First of all, the intervening role of the EU in the process of economic and political transformation was not without its doubts and failures. This was probably even more the case in the area of industrial relations. Originally, Brussels enforced the accession countries to adopt the *social acquis* in order to set up the framework for a well-functioning sectoral-level collective bargaining system and an institutionalized structure of national interest harmonization. Unluckily, however, the emphasis was put quite often on for-

¹² The term “social pact” is used quite often in two different—although to some extent overlapping—contexts in Hungary. First, the term may refer to the agreement between the cabinet and the parliamentary opposition on achieving some general objectives. Without the consensus of the rival political parties, certain decisions were not made, causing serious costs and tensions for the whole society. Csaba (2005b) for instance argued for such a political agreement among the dominant political parties in Hungary: “A credible convergence program needs to be adopted, that is based on true numbers and reflects the consensus of the main actors of the public and economic spheres. Certainly, this program would not cancel out the possibility of representing competing views and values but it would impose a strict limit to politicians’ desires” (ibid. 12). The second sense of the term, which was more common in European countries in the nineties, meant the agreement reached by the state, the employees and the employers with the explicit aim of restoring the competitiveness of the national economy and thereby securing jobs. The book applies this second interpretation of social pacts.

mal criteria only. According to Jacoby (2002), an important, if not the most important tie between the West and the East—at the time of the EU accession—was the institutional transfer that was a multidimensional and complex issue led by the EU Commission and mitigated by top politicians and their agents from the East. The emergence of so-called *organizational dualism* as a highly prevailing phenomenon among accession countries meant that formal structures were developed sometimes just because support (measured quite often in monetary terms) could be obtained from the EU if these were established. However, such formal structures sometimes just do not fit into the national structures, or are inadequate, representing time and money consuming “investments”. Formal structures degraded into ceremonial structures.¹³ Consequently, tripartism proved to be a failure in the region. Committees that were aimed at fulfilling the objectives of tripartism quite often turned out to be pure window-dressing.

Furthermore, a social pact may not be the panacea in all instances. While the wide-scale institutionalization of social partnership supported the changeover to euro in almost all countries significantly, the after-period of the EMU accession shows that the import of social pacts has deteriorated significantly. Once the target has been realized, social partners do not commit themselves cheerfully to binding rules. Recently, the net pay increase has minimally (or not at all) fallen behind productivity gains among the old members. The reform of the German welfare state has been in stall for several years—in vein of the deeply institutionalized structures of tripartism. Even the big favorites, the Irish, do not bind themselves via three-year long agreements anymore but only for six month. (See especially the warnings of Ebbinghaus 2004:586.)

More importantly, the Hungarian labor market and the wage negotiation structure is already much more deregulated than its (continental) Western counterpart (see Table 7.3). According to Thelen (2001), the fundamental differences in macro-level structures between the two ideal typical systems of market economies—namely the coordinated continental European and the liberal or segmentalist Anglo-Saxon

¹³ The screening process itself which fundamentally aimed at the disclosure of the imperfections in institution-building proved to be a failure several times. If the candidate played honestly, it might have fallen victim to the game resulting in delayed accession.

market economies—can be grasped by “the micro-level strategies pursued by *employers* as they respond to the new terms of competition” (ibid. 80).¹⁴ Accordingly, in Hungary, there is no surprise that the labor market and the employment relations are much closer to the segmentalist regime, which gravitates to the firm-level and everything above this seems to be underdeveloped, especially the sectoral level agreements. In fact, in the small and open economies of CEE countries, the global competition is even more intense than in the classical British example. Private companies (both domestic and foreign) therefore do not (and cannot) follow the logic of the collectivist strategies, where employers try to stand against the world-wide competition by coordinated wage-negotiations. Instead, each firm defends its interest by gaining a competitive edge vis-à-vis the others—quite often with the means of relatively low wage or other non-wage costs. However, while in the UK for instance, shop-floor coordination exists relatively effectively, in CEE even the workplace level is highly underdeveloped.

Table 7.3 The level of centralization and coordination of wage-setting in selected countries

	Centralization 1990–94	Centralization 1995–2000	Coordination 1990–94	Coordination 1995–2000
Hungary	1	1	1	1
Czech Republic	1	1	1	1
Poland	1	1	1	1
Ireland	4	4	4	4
Netherlands	3	3	4	4
UK	1	1	1	1

Source: OECD (2004b:151).

Remarks: data as of 2003. The scale for each variable is between 0 and 5. The higher the value, the more centralized/coordinated the structure.

Hungary is said to be the country with the most decentralized collective bargaining system among the new member states. Neumann (2002) provides an excellent study about the country by arguing that the extreme level of decentralization means that labor is not able to

¹⁴ Emphasis added.

enforce a significant influence at the company level and that it does not have an impact on the labor market at all. The author convincingly shows that the collective agreements at the company level simply do not have any significant impact either on wages or productivity (if in fact, such agreements exist at all). His most striking evidence for the ineffectiveness of working place bargaining is the statistically insignificant wage difference between unionized and non-unionized workers: a negligible 3–5 per cent wedge which is in strong contrast with the more than 10 per cent gap in the USA. The only success the labor organizations can show up is eliminating wage differentials *within* firms.

What we find here is that the Hungarian labor market is indeed at least as much (or rather more—to be precise) deregulated as their Anglo-Saxon counterparts, and the coordination structures are not simply decentralized but also *underdeveloped*. The term “deregulation” is a quasi-abusive word in continental Europe, although it does not necessarily mean the lack of negotiations between the employer and employees. Instead, liberal market economy is a different constellation of partners and their actions concentrate more at the individual level of bargaining.

In sum, the adoption of social pacts as a means to exhibit strong social support for wage demand restrictions and expenditure cuts in the general government is not a real alternative in Hungary since the wage bargaining system and the social partnership as a whole do not make this possible yet. Irrespective of the promising European examples and the technical and professional assistance of EU institutions, this country is far from being able to reach such general and comprehensive agreements at present. To the extent that social pacts are a prerequisite for fiscal sustainability, and that fiscal sustainability is indeed a prerequisite for euro-adoption, the existing lack of a social pact in Hungary is a substantial obstacle to euro-adoption.

7.4 Summary

Undoubtedly, the Hungarian labor market is among the most decentralized ones in the European Union. In principle, the flexible structure can strongly advocate the emergence of expansionary effects if the government is willing to embark on spending cuts, especially with regard to the public sector wage bill. However, the decisiveness of the government to go ahead with such politically risky fiscal measures can

also depend on the support of social partners. In Chapter 4 (section 4.3.2) it was shown that the establishment and consolidation of social partnership and the revitalization of social pacts greatly supported the success of the changeover to the euro in several European countries in the nineties. And indeed, even in Hungary (but also in other CEE countries), there is agreement among politicians and professionals alike that the creation of a social pact with a firm and comprehensive legitimacy could support the achievement of the Maastricht fiscal reference values enormously, and by doing so it could establish the ground for a long-lasting and sustainable economic growth.

While there is plenty of supportive evidence from Western Europe for the establishment of social pacts, we have argued that the launch of a successful social pact cannot be expected nowadays within the discussed political and economic constellations in Hungary. The continental European corporatist industrial relations system has not sprung into existence in the region, that is, the basic structures needed for the creation of compulsory social pacts is missing. The idiosyncratic structures do not favor stable and long-term agreements. The state has become too strong (often arrogant) and trade unions are weak and fragmented. Employers do not feel it necessary (yet) to take part in negotiations, they are obviously not interested in strengthening social partnerships.

The associations of employees and employers have not yet recognized that the delay of stabilization and the postponement of launching the single currency does not serve their interest, the establishment of a competitive Hungarian economy. The delay of reform may serve the interest of politicians in the very short term but it has to be paid by the social partners later on in the form of a loss in competitiveness and jobs. Until social partners do not recognize that the final bill has to be paid by them, that is, without the recognition of the common interest of the partners, no collective action can be expected to evolve. Furthermore, the state should also recognize that the strengthening of social partners (the creation of strong and *responsible* pressure groups) would help the cabinet to embark on reforms. Social partners could legitimate the fiscal stabilization efforts as they did so in Western Europe. The government needs partners in achieving fiscal stabilization, by providing wide-scale social support; otherwise the political willingness of the government can slip easily away.

CHAPTER 8

Conclusion

The main objective of the book was to systematically analyze whether fiscal adjustment necessarily brings about only costs in the short run or is there a chance to experience (accelerated) economic growth even in the short run and thereby offset the costs of the consolidation. While the usual interpretation of the short-term effects of fiscal consolidation takes it as given that adjustment is always affiliated with costs and is therefore politically highly unpopular, introducing the puzzle of *expansionary fiscal consolidation* is not without reason. From the eighties onwards, a large number of industrialized countries embarked on wide-scale reform programs—targeting a reduction in the debt-to-GDP ratio and reducing the level of deficit financing. It came as a surprise that fiscal adjustment was not always accompanied with the much-echoed side effect of economic slowdown, but instead some countries experienced a relatively quick recovery in economic activity. Accordingly, an increasing academic interest has been devoted to the study of short-term expansionary effects, which have been described as the non-Keynesian effects of fiscal consolidation.

The term “non-Keynesian effects” refers by definition to a situation where the fiscal multiplier turns out to be negative: the indirect effects of fiscal impetus on private consumption and/or investment offset the direct effects of government action. Such a surprising outcome is triggered by the changing behavior of rational, forward-looking private agents, who expect their tax liabilities to decline in the future and/or who work under a more competitive wage structure in the international market. Certainly, the induced change in behavior and/or in the economic environment requires an explanation. The book has been a comprehensive attempt to provide a clear and systematic analysis of this new phenomenon, combining both a theoretical and an empirical approach.

Non-Keynesian effects, however, deserve the attention of not just economists but also that of political scientists, since the issue does have political relevance. The popularity of non-Keynesian effects can be derived from the fact that by definition they lead to an accelerated economic growth even in the short term, which can be redistributed properly among citizens later, thereby reducing the risk of a government's fall and consequently facilitating fiscal reform. Being aware of the presence of the short-term expansionary effects of fiscal consolidation, politicians *in principle* should not be afraid of embarking on large-scale adjustment efforts. In fact, the likely boost to output should make it rational and desirable for politicians to implement a fiscal consolidation.

If life is indeed this simple, then why are rational politicians still reluctant to embark on fiscal consolidation? Or to put it more constructively: if the expansionary effects of fiscal contraction exist, why do only a few countries and only at certain times experience these effects, while others not at all?

The volume turned exactly to these interrelated issues by applying a critical approach to the study of non-Keynesian effects. By elaborating on the main transmission mechanisms and channels of expansionary effects, the past chapters have revealed that certain conditions must be met in order to realize the desired expansionary effects. By pointing out these necessary but surely not sufficient factors, our aim was to provide a basis for policymakers for demonstrating when exactly non-Keynesian effects can be expected to occur—if at all.

Certainly, scholars have eagerly studied the issue of non-Keynesian effects in the past few years. The European Commission or the European Central Bank for instance have officially supported these attempts. Authors in the literature on non-Keynesian effects usually put the emphasis on the need for the devaluation of the national currency, the accommodating reaction of the monetary authority and favorable international economic conditions as the necessary accompanying tools of fiscal consolidations in order to realize the unexpected outcomes (see especially McDermott and Westcott 1996 or Hagen et al. 2001). Some also emphasized the importance of the magnitude of adjustments (Giavazzi, Jappelli and Pagano 2000); while others supported the view that a high and increasing debt ratio (Blanchard 1990, Sutherland 1997 and Perotti 1999) or increasing government spending (Bertola and Drazen 1993), triggering an unavoidable adjustment, was the key to

the emergence of non-Keynesian effects. Alesina and his company, on the other hand, placed the emphasis on supply-side factors, such as the competitiveness and profitability of firms.

The volume in turn assessed these explanations critically and found that the related findings and policy suggestions are severely conditioned on several *implicit or explicit institutional assumptions* which may or may not be met in reality, seriously questioning the relevance of policy recommendations based on the simplified conceptual frameworks. Our basic message was therefore that expansionary effects may indeed exist, but in order to experience them, certain institutional conditions must be met first. Based on our critical assessment of the relevant international literature and the conduct of some European case studies and short data analyses, the following conditions can prove to be crucial in the short-term realization of expansionary effects of fiscal consolidation:

- (i) the depth of financial intermediation;
- (ii) the composition of fiscal adjustment; and
- (iii) the structure of the labor market and wage bargaining system.

The linking of non-Keynesian effects to the depth of financial intermediation (point no. (i)) is a new claim, which has not yet been made in the literature. Practically it means that by deepening financial intermediation, people can have a better access to financial markets (consumer credit for instance) and thereby they will be able to smooth their consumption much easily over their lifetime. The ability for consumption smoothing makes it more probable to react effectively to unexpected changes of fiscal policy, as it has been predicted by the permanent income/life cycle hypothesis.

As far as point no. (ii) is concerned, that is, the composition of adjustment is crucial in the experiencing of non-Keynesian effects, the book tried to verify an already existing and widely-discussed tenet, which, however, in itself is not independent from other factors, especially political willingness and the structure of the labor market and the wage bargaining system, discussed under point no. (iii).

It needs to be emphasized once again that the political relevance of the issue is extremely important, since the naïve belief that based on some simple policy recommendations each and every fiscal consolidation results in short-term growth effects is simply not true. Politicians

must be aware of those institutional conditions which can or cannot facilitate the emergence of non-Keynesian effects. Consequently, it might be important to create and/or strengthen the prevalence of those factors without which there is hardly any hope to experience an acceleration in economic activity at times of fiscal contraction.

8.1 Non-Keynesian effects at work

Undoubtedly, a widely shared consensus has been forming in mainstream economics and public policy analysis, namely that sound fiscal performance is conducive to medium and long-term economic growth. A responsible government should not overheat the economy with the declared attempt to realize short-term benefits. The government-led, artificial pursuit of an unsteady increase of aggregate demand undermines both potential economic growth and the ability to finance the general government, causing a suboptimal economic outcome (Erdős 2000). Yet, the short-term effects of fiscal consolidation on economic performance are still hotly debated. While a fiscal adjustment necessarily comes hand in hand with a direct fall in aggregate demand, it may also trigger *indirectly* an offsetting mechanism by the increased consumption and/or investment of the rational and forward-looking agents of the private sector in the short term already. The fact that this is not just a theoretical invention but a real possibility has been highlighted in Chapter 2, where the exceptional fiscal episodes (contractions) of a large sample of European countries were analyzed with the aim of finding some specific sample characteristics. The major observations were then the following:

- (i) Fiscal contraction is not always accompanied by an economic decline in the short run; in fact, there are some instances when economic activity does accelerate.
- (ii) The size of adjustment *alone* is not a good predictor concerning either the persistence or the expansionary effect of fiscal consolidation.

The descriptive data analysis of exceptional fiscal episodes and their consequences presented in Chapter 2 is not without doubts, however. Admittedly, fiscal adjustment and an acceleration of economic activity might have been just a simple coincidence and not a casual rela-

tionship of the two. Still, the relatively large number of such “mere chances” (almost half of the total episodes proved to be expansionary) should provide food for thought. Accordingly, we wished to understand the mechanisms and conditions that enable policy-makers to undertake a fiscal consolidation without being threatened to be voted out from power and thereby to reverse and delay reform until a crisis with serious short-term macroeconomic consequences compel the government to initiate costly changes in the previous fiscal course.

In Chapters 3 and 4, by critically assessing the literature on non-Keynesian effects, three basic channels have been distinguished through which the offsetting mechanisms can emerge. The classical *credibility effect* put the emphasis on the decline in risk premia, due to a deliberate and credible adjustment effort implemented by the government. In this case, the size of adjustment can prove to be crucial since the bigger is the adjustment, the less likely a reversal of the fiscal consolidation will occur, thereby individuals’ financial assets will be revaluated. The second channel, described by the *expectational view* of fiscal policy, concentrates on changes in permanent income. These more recent studies—developed mostly in the nineties—focus on the change in the expected future tax liabilities of rational individuals by assuming that initial conditions such as the critically high level of debt or government spending (or the acceleration of one of these) will trigger a change in individuals’ consumption decision. Last but not least, the *investment or supply-side channel* has gained an increased attention recently by arguing that lowering the cost of labor—triggered by public expenditure cuts for instance—will increase the competitiveness of the whole economy in international markets and thereby private investments as well. The focus of the book was, however, restricted on the second and third channels exclusively and did not deal with the credibility effect in length, since this has already been widely discussed in the literature.

Demand-side explanations operate with the changes in individuals’ expectations regarding their future disposable income in times of fiscal consolidations. In its most simplified version, the expectational view of fiscal policy claims that a tax increase, given government spending, might generate expansion in private consumption. Among others, Blanchard (1990) showed that there are two ways by which government consolidation through taxes can affect expectations. First, the traditional one: an intertemporal redistribution of taxes from tomorrow to today which in turn reduces current generations’ consumption. This

effect is the stronger as long as consumers behave in a Keynesian manner. However, there is a second channel, too: if the government is ready to take restrictive measures, the likelihood of the need for a much larger and more disruptive future fiscal retrenchment will be eliminated, which can in turn increase private consumption today. That is, if consolidation takes place before a critically high value of the debt level has been reached (which proves to be unsustainable), the economy can be saved from a catastrophe which is good news to everyone. The tax increase today, aiming at consolidating the fiscal stance, transforms expectations towards a less distortionary taxation tomorrow and individuals will in turn expect their permanent income to increase and thereby they will consume more and save less in the present. It is exactly this increase in private consumption which can compensate for the reduced government consumption in case of a fiscal adjustment. If the increase in private spending can indeed *offset* the direct negative effects of increased public revenues on aggregate demand, then fiscal contraction can be expansionary.

While the demand-side interpretations can prove to be a theoretically appealing and challenging explanation for non-Keynesian effects by combining both Keynesian and Ricardian behavior within the same models, its empirical justification is still inconclusive. A deconstruction of the theory of the expectational view in Chapter 3 partly showed why empirical support is still quite rare. As it has been demonstrated, the expectational view bases its conceptualization of non-Keynesian effects on the combination of the rational expectations theory and the permanent income hypothesis. Its main claim is that rational, forward-looking consumers are able to react effectively to policy changes via the modification of their expectations of wealth and permanent income. It is, in fact, the *change* in permanent income that triggers a boost in economic activity when government embarks on fiscal adjustment.

However, by focusing on modern consumption theory, it has been revealed that one of the basic assumptions of the expectational view, namely the lack of liquidity constraint, can strongly invalidate the practical usage of the theory. But on the other hand, from a purely policy viewpoint, it also reveals how important *financial deepening* can be if the aim is to weaken credit constraint and to increase the chance for countries to experience expansionary fiscal consolidations. This was indeed one of the most important findings of the book.

Chapter 4 turned to the supply-side explanations of non-Keynesian effects and demonstrated that the composition of adjustment can prove to be highly decisive in the success of fiscal consolidation. As opposed to the demand-side approaches, in this case it was the rational, forward-looking *firm* which tried to maximize the expected present value of future cash flow and decided on the current level of investment accordingly. Any decline in real wage reduces the capital–labor ratio and increases the marginal product of capital, thereby increasing profit and investment. However, improved competitiveness of firms on international markets can be expected only if politicians are willing to initiate fiscal adjustment on the *expenditure*-side of the general budget.

The chapter advocated the hypothesis that expenditure cuts, especially in the public sector wage bill and welfare transfers were more likely to end up in a debt-reducing and growth-promoting stabilization than a revenue-side consolidation. In accordance with the empirical literature, our data analysis on the sample of EU-14 showed that permanent (that is, debt-reducing) adjustment was achieved by expenditure-based adjustment in two-thirds of the cases, while 70 per cent of the unsuccessful (non-permanent) consolidations were implemented by revenue-based adjustments. It was also demonstrated that expansionary effects in times of fiscal contractions can be experienced in both revenue- and expenditure-based consolidations, however, cutting back expenditures can guarantee the occurrence of non-Keynesian effects with substantially higher probability. Yet, more than half of the adjustment episodes were still pursued by increasing revenues, and only one government out of three was willing to initiate fiscal consolidations by cutting back public spending in the EU-14 between 1980 and 2004. That is, politicians seemed to be rather unwilling to choose the politically more risky approach to consolidation.

The results are indicative also in the sense that these findings disprove the general conviction which suggests that it is the size of adjustment alone that determines the success and the macroeconomic consequences of fiscal stabilization. The fact that a government is able to reduce the deficit by some percentage points does not mean yet that it has implemented a persistent and successful adjustment. It was argued instead that quality (composition) might be a much better predictor regarding the short-term effects of fiscal consolidation. The dispute on “size” versus “composition” gains significance especially if it is taken into account that the standard textbook approach is to focus on the size

of consolidation only, while composition is left in the dark. Nevertheless, from the point of view of economic policy, the real challenge is manifested in *composition*, since this is where politically sensitive decisions are taken, i.e. who will bear the burden of adjustment.¹

We have shown accordingly that a consensus view on fiscal consolidation seems to emerge: cutting back politically sensitive items should be a constitutive part of any adjustment effort which aims at restoring fiscal balance and sustainability. Hesitance to tackle politically sensitive items of the general budget results in unsuccessful attempts, meaning that the problem of unsustainable public finances has not been solved but only postponed. Accordingly, *political decisiveness*—a totally neglected area of research on non-Keynesian effects—can prove to be crucial in the success of fiscal adjustment. Without the political willingness of policy-makers to turn to the expenditure side of the general budget, the ultimate effects of any stabilization efforts may strongly be questionable.

Cutting back the compensation of public sector employees and welfare transfers paid to households are indeed considered to be the politically most sensitive elements of the budget; the constitutive parts of any welfare state. The issue of political willingness turned our attention therefore to the experience of successful European countries, which experienced non-Keynesian effects during the eighties and nineties. Consequently, the importance of *social pacts* was placed at the very heart of our analysis. In general, social pacts reflected the recognition that both employers and employees could mutually benefit from an agreement which pushed labor markets in the direction of more flexibility but kept wage negotiations in a highly coordinated framework, which enabled the partners to strike an agreement on wage accords.

Social agreements received a distinctly new character in Europe from the late eighties onwards. These redesigned agreements did not wish to widen and further burden the social security system along with providing more welfare measures. Instead, the revival of social pacts aimed at reforming the welfare state itself, quite often by restricting

¹ Importantly, it has not been argued that size of adjustment is irrelevant. Certainly, if a government wants to signal its determinacy, it has to initiate a sizable, robust adjustment; otherwise markets do not consider the attempt as credible. Yet, the ultimate macroeconomic effects are basically determined by the quality of adjustment.

Table 8.1 Conditions of Keynesian and non-Keynesian effects

Keynesian effects positive fiscal multiplier	Non-Keynesian effects negative fiscal multiplier
• closed economy • slacks in the economy • rigid prices • fixed exchange rate regime • restricted time-horizon • liquidity constrained individuals • non-perfect money and capital markets • short-sighted individuals • public and private consumption are complementary • balanced budget position (imbalances are temporary only) • low initial debt-to-GDP ratio • low level of public spending • low (or zero) risk premia • political indecisiveness and non-credible actions in times of adjustment • tax hikes (putting the burden on households and companies) • rigid labor markets • the lack of public support • unfavorable international economic conditions	• open economy • economy functioning at full capacity • flexible prices • flexible exchange rate regime • infinitely lived individuals • no liquidity constraint • perfect money and capital markets • forward-looking individuals • public and private consumption are competitive • deteriorated budget balance (an unsustainable position) • high and accelerating debt-to-GDP ratio • high and accelerating public spending • high risk premia • political decisiveness and credible actions in times of adjustment • expenditure cuts (reducing politically sensitive items of the general budget) • flexible labor markets • strong social support (the relevance of social pacts) • favorable international economic conditions

Source: own construction.

Remarks: The exhaustive list certainly cannot mean that each condition should be present at the same time in order to experience either the Keynesian or the non-Keynesian effects. The list instead contains all the main assumptions and conditions that are applied by the rationalizations of either the positive or the negative fiscal multiplier.

the range of and the access to certain entitlements. The competitiveness of companies and the security of jobs were believed to be maintained only by the full internalization of the wage demand costs. Consent in some countries to reform welfare provisions made it possible to

embark on wide-scale stabilization programs by cutting back the politically sensitive budget items along with other measures to reform the labor market itself, as it was documented especially in the case of the Netherlands and Ireland.

In sum, in the first part of the book (Chapters 2–4), it has been documented that both demand-side and supply-side conceptualizations of non-Keynesian effects are highly sensitive to (some) institutional factors. The depth of financial intermediation, the composition of adjustment and the structure of the labor market and wage bargaining system are decisive whether a country will experience the desired short-term growth effects or not. In the presence of liquidity constraints or inflexible labor markets, the ultimate macroeconomic results of an adjustment in the short term can prove to be doubtful. The neglect of these factors can cause serious disappointment if a government embarks on fiscal consolidation with the false hope of experiencing expansionary effects even in the short term. The disillusionment will in turn stop further reform and/or will put it in reverse, thereby resulting in an even worse situation than without the initial adjustment. An extended list of conditions for experiencing Keynesian versus non-Keynesian effects can be found in Table 8.1.

8.2 The Hungarian relevance of non-Keynesian effects

The basic message of Part One was that the expansionary effects of any fiscal consolidation are much conditioned on some crucial institutional factors. By identifying the most relevant institutional factors, it became also possible to test the relevance of each factor in a selected country in order to get an insight whether the chosen country would be able to experience non-Keynesian effects.

Hungary has been selected for this specific purpose for two main reasons. This is the country in the EU (i) with the largest deficit at present which makes the early adoption of the single currency highly unlikely; and (ii) the most in need to embark on a major fiscal consolidation in the near future without which there is no hope for the country to perform on its potential rate of economic growth.²

² Nevertheless, the elaborated framework of the analysis with the three institutional conditions (presented in Part One) is suitable for any country—this can be indeed one the main assets of the book.

Hungary has two options at the moment: either politicians realize the need for initiating fiscal adjustment or they take the position of wait-and-see. In the latter case, an exogenous shock will enforce the fiscal consolidation sooner or later, without providing any room for reducing the costs of adjustment. In the former case, however, there is still a chance to minimize the costs of the stabilization attempts or possibly to implement a consolidation with positive short-term growth effects.

It has often been pointed out in the literature that the likelihood of realizing expansionary effects in times of fiscal contraction is higher if the stabilization efforts are pursued with a depreciation of the national currency and/or the loosening of monetary policy. Both elements were significant parts of the 1995 austerity package, which was the only clear attempt to put a stop to fiscal profligacy in the last fifteen years. The consequent surprise inflation and the dramatic erosion of real wages contributed substantially to the improvement of international competitiveness and the increased export sector activity of the country. Rzonca and Cizkowicz (2005) have argued accordingly that the relatively quick recovery of the economic performance two years after the shock therapy was basically triggered by the boost of export sector performance.

However, neither the devaluation of the national currency, nor a lax monetary policy can be expected to accommodate fiscal consolidation in Hungary *nowadays*, since none of these policies are allowed to be followed under the Maastricht rules and the Stability and Growth Pact. Member countries of the European Union cannot use devaluation as a device to gain competitiveness vis-à-vis the rest of the Community. Moreover, monetary authorities cannot be pressurized to ease monetary policy, since the primary objective of central banks is to keep inflation at bay. The only way forward is to implement a credible and severe fiscal consolidation. Consequently, a proper understanding of how the demand and supply-side channels work in delivering expansionary effects in times of fiscal adjustment and what institutional factors can contribute to the minimization of consolidation costs is extremely important. In Part Two, therefore, a critical look of the Hungarian economy—concentrating on (i) the financial intermediation system, (ii) the structure of the general budget and (iii) the labor market and wage bargaining system—has been taken in order to clarify whether the country is able to experience non-Keynesian effects.

For sure, a credible adjustment could substantially reduce *risk premia* in a country where the debt-to-GDP ratio—as compared to the level of development—is extremely high, much above the Maastricht reference value of 60 per cent, approaching 70 per cent in 2006.³ The reduced risk premia may induce a decline in the market interest rate, which in turn can have two subsequent effects on the real economy. On the one hand it can crowd in *private investment*, thereby boosting aggregate demand and on the other hand it can also revalue the nominal value of individuals' financial assets, inducing privates to spend more on consumption. The increased level of private investment and consumption can offset the negative effect of government expenditure cuts and/or tax increase on the aggregate demand, thereby providing a chance for a reduced or even negative multiplier to emerge. Several assumptions should be met, however. First, the consolidation effort must be credible and should promise permanent and adequate changes. Second, large adjustments are more likely to end up with a drop in risk premia as opposed to small-sized consolidations, because political commitment seems to be more explicit in the former case. Third, private consumption can be expected to accelerate via the wealth channel only if Hungarian households possess a positive and significantly large net wealth, which is definitely not the case today in a country where the household sector was even in a negative net saver position in the new millennium for some time.⁴

In line with the main results of Chapter 3, a critical look at the Hungarian *financial intermediation* was taken in Chapter 5 in order to analyze whether financial intermediation is deep enough and the liquidity constraint is weak enough to facilitate the occurrence of expansionary effects. It was argued for instance that the forthcoming euro-adoption can extensify substantially credit growth in Hungary. Based on the earlier experiences of the cohesion EU countries, the preparation for the adoption of the single currency and the introduction itself will expectedly deepen financial intermediation further. Moreover, as a part of the

³ According to estimates, the sustainable level of the Hungarian debt would be around 40 per cent of the GDP. See especially Orbán and Szapáry (2004).

⁴ On the positive side, it is worth adding that by reducing the risk of default, the decreased market interest rate may also reduce the interest payment of the general government, providing room for compensating the net losers of fiscal contraction.

real convergence process, financial deepening will hopefully increase as well, easing the liquidity constraint of households and thereby providing a better chance for individuals to base their consumption decisions on changes in their future tax liabilities.

In Chapter 3, however, it was implicitly assumed that the deepening of financial intermediation is an endogenous process, highly conditional on economic development. In Hungary, nevertheless, the sudden increase of credit availability to households can be partly traced back to fiscal laxity. In the last few years, the apparently stable and solid banking sector has moved vigorously towards households in its lending activity. The household credit expansion coincided with the deterioration of fiscal performance, however. Therefore we took the risk in Chapter 5 to claim that the sudden credit expansion (and the easing of liquidity constraint) was in fact mostly due to fiscal profligacy and cannot be considered as an organic development process of financial markets. Consequently, a fiscal consolidation can make the liquidity constraint more severe again, hindering the emergence of non-Keynesian effects.⁵ Moreover, it was also pinpointed that Hungarian households are more inclined to increase precautionary savings at times of adjustment, which also prevents individuals from increasing their current consumption in times of fiscal contraction. We also saw in section 5.6, however, that the restrictions on housing subsidies and the relatively high domestic interest rate from 2004 onwards did not reduce Hungarians' appetite for loans. Instead they started to borrow in foreign currencies, thereby substantially increasing the vulnerability of the household sector. A negative shock would seriously undermine therefore the financial position of Hungarian households, and possibly the banking sector as well.

In sum, as far as the demand side is concerned, the reduced risk premia may have a counterbalancing effect against the negative consequences of a fiscal adjustment on aggregate demand, but these effects will hardly be enough to fully compensate for the loss.

⁵ Importantly, economic development and the deepening of financial intermediation is not simply a one-way relationship, as they can be related to each other the other way around as well. That is, strengthening and deepening financial intermediation can also contribute to economic development. Consequently, the government can have a substantial role in creating and maintaining an environment that is conducive to the proliferation of financial intermediation.

Turning to the supply-side interpretations of non-Keynesian effects, the structure of the Hungarian general government was scrutinized in Chapter 6. Following the record-high deficit of 2002, a close to 8 per cent gap between total revenues and expenditures was experienced in 2005 again.⁶ Since fiscal consolidation cannot result in the deterioration of the competitiveness of the private sector in international markets, *a tax-based consolidation should not be the way forward* in Hungary at the moment. What remains, therefore, is a substantial cutback on the expenditure-side, which is a highly unpopular political decision.

By reviewing the composition of the budget, it has been revealed that over-employment became a serious defect in the public sector. One-fourth of the total employees work in the public sector, illustrating convincingly that the state administration might be lacking in efficiency. Although the state provides labor opportunity for (too) many, still, the labor force participation ratio is the lowest among OECD countries, much below 60 per cent. The wage policy, conducted in the last few years, made state employment appealing for people, thereby devaluating the attractiveness of the private sector for potential workers.

Transfers to households have also been increased substantially in the years of the new millennium. The structure of welfare spending, nevertheless, still suffers from serious distortions. Spending on health care and education is still lower than in the EU-15, and moreover, their effectiveness have been damaged seriously. On the other hand, sick pay and disability pay are much more generous and early retirement schemes are disincentives to employment, too. The disincentive structure of social protection makes non-participation in the labor market appealing for many. Subsidies on pharmaceuticals or housing also contributed to the deteriorated fiscal performance. Interestingly, economic functions conducted by the Hungarian state often serve the interest of households, therefore price regulations or subsidies can be considered as welfare benefits as well.

Importantly, the failed wage policy and the generous welfare provisions exercised in the last couple of years by the alternating governments did not simply result in a one-time pressure on the general budget.

⁶ According to the latest 2006 estimates, the general government deficit has reached 10.1 per cent of the GDP.

The tax-free minimum wages and increased public sector salaries mean a substantial future commitment in the budget that can prove to be extremely hard to be taken back later on. Also, the proliferating examples of increased family allowances or the relatively high and rising number of disability benefits and sick pays, the incredibly high share of people with early retirement schemes prove that citizens consider such benefits as entitlements which are simply not part of the annual budgeting debate. Once people have been entitled to receive them, they show strong political resistance if the government tries to reduce or eliminate any of these. The remedy of these structural deficiencies therefore demands a complex set of measures, which may prove to be highly unpopular.

If the deterioration of the fiscal performance can be traced back basically to the increase of those budget elements which are considered to be the politically most sensitive ones, their reduction can prove to be hard to implement in the future. Chapter 4 showed that (i) public support in the form of social pacts and/or (ii) deregulated labor markets can help the cabinet enormously to embark on these rather unpopular measures. While the Hungarian labor market can be characterized as a highly decentralized one and therefore cutbacks in the public expenditure might have the desired effect of increasing profit expectations and accelerated private investment, politicians may still be reluctant to undertake such restrictive measures since the current political and economic constellation in Hungary is not suitable for the introduction of a binding social pact—as it has been revealed in Chapter 7.⁷

In the vein of the numerous, highly constructive examples of the old member states of the EU, a strengthened partnership and the revitalization of social pacts cannot be the way forward in order to achieve fiscal reform and euro adoption in the country. Hungarian social partners are weak, fragmented and hostile to each other or are simply uninterested to reach an agreement. There is an immense lack of dominant partners—that is, pressure groups—who can set up a *credible* time-

⁷ The Hungarian labor market is relatively flexible indeed. However, the failed wage policy of 2001–2003, eroded the flexibility of nominal wages and made employment in the public sector unjustifiably attractive. Moreover, the replacement of labor for capital has become an imminent feature of the Hungarian economy in the last few years, eroding flexibility to some extent.

table for the euro-zone accession and who are able to provide the much-needed consent on the inevitable reform measures with respect to the general government. Certainly, a collective action problem prevails among the actors. Social partners have not yet recognized that the delay of stabilization and the postponement of launching the euro does not serve their interest, namely the establishment of a competitive Hungarian economy vis-à-vis the rest of the world.

However, without a social pact, the adoption of the single currency may prove to be an unreasonably difficult and burdensome task in the country. Social pacts are not simply wage-agreements, but also facilitate the restructuring of the general government, the streamlining of the public sector and the reduction of deficit. In a longer perspective, social pacts can endorse fiscal sustainability, too; therefore, it would be a highly rational move to start rethinking the structure and institutions of social partnership in Hungary.

In sum, while there may evolve some sources by which the negative short-term macroeconomic consequences of a fiscal adjustment can be cushioned in Hungary—especially through the credibility channel—it is still unlikely that the overall fiscal multiplier could turn into negative, thereby providing an acceleration of economic growth even in the short run. This hypothesis was supported also by Horváth et al. (2006). Nevertheless, it must also be emphasized that in the current situation Hungary has no other option than to go ahead with a far-reaching fiscal consolidation, otherwise international market forces will force the country to adjust—however, such a scenario would be more costly for both politicians and voters for sure.

Certainly, fiscal consolidation is always associated with costs—whether it is initiated in Ireland, the Netherlands or Hungary. It is no surprise that politicians may find their popularity to decline (sometimes dramatically) after announcing restrictions in the general budget. Nevertheless, a widely-shared consensus has been forming nowadays in economic policy on the highly beneficial consequences of well-designed fiscal adjustment—especially concerning its long-term effects. Without pursuing fiscal discipline, it is hardly likely that sustainable economic growth can be achieved in small and open economies such as European states.

While the long-term consequences of adjustment may have the favorable consequences of a higher potential rate of economic growth and an increased social welfare, the short-term costs can easily scare

off incumbents to undertake unpopular measures. Accordingly, what should be achieved is the possible minimization of the short-term sacrifices of fiscal retrenchment in order for politicians to be brave enough to initiate the necessary steps.

In principle, fiscal consolidations may have expansionary effects as it has been documented in some instances in the last two decades. However, this book showed that such “perverse effects”, that is, the shift of the fiscal multiplier into negative, is highly conditional on several explicit and implicit assumptions that may or may not be at present in a given country and at a particular time.

The critical but constructive assessment of the literature on non-Keynesian effects, the descriptive data-analysis conducted on the sample of 14 EU countries and the qualitative case study on Hungary together focused our attention on the importance of those transmission channels, and more importantly those institutional factors, that may hopefully accommodate the occurrence of the unexpected outcomes. It is much hoped, therefore, that this book has made some contributions to the debate on the legitimization of fiscal consolidation—a political act which had been previously considered as the synonym of a necessary fall.

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Appendix 1

Exceptional fiscal episodes: adjustments (Definition 1a)

Episode	Size of adjustment	Episode	Size of adjustment
Austria 1984	2.40	Greece 1994	5.23
Austria 1996	1.78	Greece 1996	1.97
Austria 1997	1.67	Ireland 1982	2.62
Austria 2001	2.45	Ireland 1983	3.09
Belgium 1982	5.00	Ireland 1987	1.67
Belgium 1984	3.96	Ireland 1988	2.74
Belgium 1985	1.62	Ireland 1989	1.52
Belgium 1993	2.06	Ireland 2003	1.58
Germany 1989	2.1	Italy 1982	3.45
Denmark 1983	3.77	Italy 1983	1.80
Denmark 1984	2.53	Italy 1991	1.73
Denmark 1986	1.93	Italy 1992	2.26
Denmark 1999	1.80	Italy 1993	1.78
Spain 1992	2.02	Italy 1997	2.01
Finland 1981	2.07	Netherlands 1982	1.55
Finland 1984	1.88	Netherlands 1991	3.25
Finland 1988	2.50	Netherlands 1993	3.21
Finland 1993	1.85	Netherlands 1996	1.96
Finland 1998	1.50	Portugal 1982	2.49
Finland 2000	2.98	Portugal 1983	3.93
France 1996	1.89	Portugal 1986	1.84
UK 1980	2.67	Portugal 1988	1.57
UK 1996	1.50	Portugal 1992	3.17
UK 1997	1.82	Portugal 2002	2.33
UK 1998	2.00	Sweden 1981	3.00
Greece 1982	1.57	Sweden 1983	1.60
Greece 1986	2.51	Sweden 1986	1.99
Greece 1987	2.47	Sweden 1987	2.69
Greece 1991	3.96	Sweden 1996	4.51

Source: own calculations based on OECD (2005a).

Remarks: in accordance with *Definition 1a*, primary government balance data (cyclically adjusted, per cent of the potential GDP) were used to calculate the size of adjustment.

**Exceptional fiscal episodes: adjustments
(Definition 1b)**

Episode	Size of adjustment (cumulative change)
Austria 1996–97	3.45
Belgium 1984–85	5.58
Denmark 1983–84	6.3
UK 1996–97	3.32
UK 1997–98	3.82
Greece 1986–87	4.98
Ireland 1982–83	5.71
Ireland 1987–88	4.41
Ireland 1988–89	4.26
Italy 1982–83	5.25
Italy 1991–92	3.99
Italy 1992–93	4.04
Portugal 1982–83	6.42
Sweden 1986–87	4.68

Source: own calculations based on OECD (2005a).

Remarks: in accordance with *Definition 1b*, primary government balance data (cyclically adjusted, per cent of the potential GDP) were used to calculate the size of adjustment.

Exceptional fiscal episodes: expansion (Definition 1a)

Episode	Size of expansion	Episode	Size of expansion
Austria 1984	2.40	Greece 1985	3.1
Austria 1996	1.58	Greece 1988	2.46
Belgium 1980	1.81	Greece 1989	2.7
Belgium 1981	3.27	Greece 1995	2.19
Germany 1990	2.1	Greece 2000	2.69
Germany 2001	1.57	Ireland 1990	2.38
Denmark 1982	2.7	Ireland 1999	1.65
Denmark 1994	1.96	Ireland 2001	3.97
Spain 1982	1.58	Italy 1981	2.81
Finland 1982	1.89	Netherlands 1986	1.72
Finland 1987	3.41	Netherlands 1989	2.85
UK 1983	1.65	Portugal 1985	2.42
UK 1990	1.56	Portugal 1993	2.7
UK 1992	2.3	Sweden 1992	6.73
Greece 1981	4.3	Sweden 2002	2.28

Source: own calculations based on OECD (2005a).

Remarks: in accordance with *Definition 1a*, primary government balance data (cyclically adjusted, per cent of the potential GDP) were used to calculate the size of expansion.

Exceptional fiscal episodes: expansion (Definition 1b)

Episode	Size of expansion (cumulative change)
Belgium 1980–81	5.08
Greece 1988–89	5.16

Source: own calculations based on OECD (2005a).

Remarks: in accordance with *Definition 1b*, primary government balance data (cyclically adjusted, per cent of the potential GDP) were used to calculate the size of expansion.

Appendix 2

Persistent and non-persistent fiscal adjustments (Definition 2)

Episode	Size of adjustment	Size of debt reduction
Austria 1984	2.40	-11.14
Austria 1996	1.78	-0.03
Austria 1997	1.67	-2.26
Austria 2001	2.45	3.17
Belgium 1982	5.00	-19.4
Belgium 1984	3.96	-14.13
Belgium 1985	1.62	-14.26
Belgium 1993	2.06	8.18
Germany 1989	2.1	-2.20
Denmark 1983	3.77	3.94
Denmark 1984	2.53	9.19
Denmark 1986	1.93	6.66
Denmark 1999	1.80	6.56
Spain 1992	2.02	-17.3
Finland 1981	2.07	-3.34
Finland 1984	1.88	-2.75
Finland 1988	2.50	-5.95
Finland 1993	1.85	-8.30
Finland 1998	1.50	9.91
Finland 2000	2.98	1.08
France 1996	1.89	0.22
UK 1980	2.67	4.49
UK 1996	1.50	3.75
UK 1997	1.82	7.32
UK 1998	2.00	12.65
Greece 1982	1.57	-17.5
Greece 1986	2.51	-18.30
Greece 1987	2.47	-26.59
Greece 1991	3.96	-25.75
Greece 1994	5.23	-6.10
Greece 1996	1.97	-1.10
Ireland 1982	2.62	-20.30
Ireland 1983	3.09	-18.05
Ireland 1987	1.67	17.66

Episode	Size of adjustment	Size of debt reduction
Ireland 1988	2.74	12.63
Ireland 1989	1.52	6.33
Ireland 2003	1.58	n.a.
Italy 1982	3.45	-17.10
Italy 1983	1.80	-16.54
Italy 1991	1.73	-16.85
Italy 1992	2.26	-7.01
Italy 1993	1.78	-11.05
Italy 1997	2.01	8.68
Netherlands 1982	1.55	-16.35
Netherlands 1991	3.25	1.27
Netherlands 1993	3.21	7.90
Netherlands 1996	1.96	15.63
Portugal 1982	2.49	-12.4
Portugal 1983	3.93	-11.20
Portugal 1986	1.84	3.90
Portugal 1988	1.57	3.10
Portugal 1992	3.17	9.90
Portugal 2002	2.33	-9.92
Sweden 1981	3.00	-15.57
Sweden 1983	1.60	-0.14
Sweden 1986	1.99	19.32
Sweden 1987	2.69	15.70
Sweden 1996	4.51	12.95

Source: own calculations based on OECD (2005a).

Remarks: in accordance with *Definition 1a* and *Definition 2*, primary government balance data (cyclically adjusted, per cent of the potential GDP) and gross government debt (per cent of the GDP) were used to calculate the size of adjustment and the size of debt-reduction.

Negative sign means an increase in the debt-to-GDP ratio.

In case of Greece, the data on debt was obtained from the European Commission (2005) because the OECD (2005a) data set had not yet contained the revisions initiated by the European Commission due to the earlier Greek practice of creative accounting.

Appendix 3

Expansionary and contractionary fiscal consolidations (Definition 3a and 3b)

Episode	Size of adjustment	Average growth during and after (1)	Average growth before (2)	Difference of averages (1-2)*	Average growth of EU-15 during and after (3)	Difference of averages (1-3)**
Austria 1984	2.40	1.63	2.50	-0.87	2.60	-0.97
Austria 1996	1.78	2.50	2.10	0.40	2.30	0.20
Austria 1997	1.67	2.73	1.80	0.93	2.80	-0.07
Austria 2001	2.45	0.96	2.90	-1.94	1.20	-0.24
Belgium 1982	5.00	1.13	1.60	-0.47	1.80	-0.67
Belgium 1984	3.96	2.00	0.45	1.55	2.60	-0.60
Belgium 1985	1.62	1.93	1.40	0.53	2.70	-0.77
Belgium 1993	2.06	1.53	1.65	-0.12	1.60	-0.07
Germany 1989	2.10	4.90	2.60	2.30	3.00	1.90
Denmark 1983	3.77	2.93	0.30	2.63	2.26	0.67
Denmark 1984	2.53	3.70	2.20	1.50	2.60	1.10
Denmark 1986	1.93	1.73	3.55	-1.82	3.26	-1.53
Denmark 1999	1.80	2.56	2.75	-0.19	2.87	-0.31
Spain 1992	2.02	0.76	2.70	-1.94	1.17	-0.41
Finland 1981	2.07	2.70	6.15	-3.45	0.97	1.73
Finland 1984	1.88	2.97	3.00	-0.03	2.60	0.37
Finland 1988	2.50	3.06	3.30	-0.24	3.60	-0.54
Finland 1993	1.85	2.03	-5.10	7.13	1.60	0.43
Finland 1998	1.50	4.50	5.10	-0.60	3.13	1.37
Finland 2000	2.98	2.70	4.20	-1.50	2.85	-0.15
France 1996	1.89	2.13	1.90	0.23	2.30	-0.17
UK 1980	2.67	-0.53	3.10	-3.63	3.10	-3.63
UK 1996	1.50	3.00	3.60	-0.60	2.30	0.70
UK 1997	1.82	3.07	2.75	0.32	2.80	0.27
UK 1998	2.00	3.23	3.00	0.23	3.13	0.10
Greece 1982	1.57	-0.77	-0.45	-0.32	1.80	-2.57
Greece 1986	2.51	0.83	2.25	-1.42	3.26	-2.43
Greece 1987	2.47	1.93	1.50	0.43	3.53	-1.60
Greece 1991	3.96	0.73	1.90	-1.17	0.83	-0.10
Greece 1994	5.23	2.16	-0.45	2.61	2.27	-0.11
Greece 1996	1.97	3.13	2.05	1.08	2.30	0.83

Episode	Size of adjustment	Average growth during and after (1)	Average growth before (2)	Difference of averages (1-2)*	Average growth of EU-15 during and after (3)	Difference of averages (1-3)**
Ireland 1982	2.62	2.13	4.00	-1.87	1.80	0.33
Ireland 1983	3.09	2.40	2.80	-0.40	2.26	0.14
Ireland 1987	1.67	5.06	1.70	3.36	3.53	1.53
Ireland 1988	2.74	6.03	2.50	3.53	3.60	2.43
Ireland 1989	1.52	5.80	4.50	1.30	3.00	2.80
Ireland 2003	1.58	n.a.	6.55	n.a.	n.a.	n.a.
Italy 1982	3.45	1.53	2.05	-0.52	1.80	-0.27
Italy 1983	1.80	2.33	0.70	1.63	2.26	0.07
Italy 1991	1.73	0.43	2.15	-1.72	0.83	-0.40
Italy 1992	2.26	0.70	1.85	-1.15	1.17	-0.47
Italy 1993	1.78	1.40	1.10	0.30	1.60	-0.20
Italy 1997	2.01	1.83	2.00	-0.17	2.80	-0.97
Netherlands 1982	1.55	1.20	1.25	-0.05	1.80	-0.60
Netherlands 1991	3.25	1.53	3.15	-1.62	0.83	0.70
Netherlands 1993	3.21	2.20	1.95	0.25	1.60	0.60
Netherlands 1996	1.96	3.70	2.95	0.75	2.30	1.40
Portugal 1982	2.49	0.00	3.10	-3.10	1.80	-1.80
Portugal 1983	3.93	0.23	1.85	-1.62	2.26	-2.03
Portugal 1986	1.84	6.00	0.45	5.55	3.26	2.74
Portugal 1988	1.57	5.97	5.25	0.72	3.13	2.84
Portugal 1992	3.17	0.33	3.85	-3.52	1.17	-0.84
Portugal 2002	2.33	0.27	2.95	-2.68	1.50	-1.23
Sweden 1981	3.00	0.97	2.75	-1.78	0.97	0.00
Sweden 1983	1.60	2.80	0.30	2.50	2.26	0.54
Sweden 1986	1.99	2.93	3.25	-0.32	3.26	-0.33
Sweden 1987	2.69	2.90	2.50	0.40	3.53	-0.63
Sweden 1996	4.51	2.45	4.15	-1.70	2.30	0.15

Source: own calculations based on OECD (2005a) and European Commission (1999 and 2005).

Remarks: *: positive sign refers to a non-Keynesian effect (*Definition 3a*); **: positive sign refers to a non-Keynesian effect (*Definition 3b*).

**Changes in private and government consumption and direct taxes during
non-Keynesian episodes (Definition 3a)**

	Change of private consumption			Change of government consumption			Change in direct taxes		
	t-1	t	t+1	t-1	t	t+1	t-1	t	t+1
Austria 1996	2.9	2.0	0.7	0.0	0.6	-3.9	7.21	1.3	8.2
Austria 1997	2.0	0.7	2.1	0.6	-3.9	1.31	1.3	8.2	5.0
Belgium 1984	-0.9	0.6	2.0	0.3	0.6	2.5	-1.8	5.1	-0.8
Belgium 1985	0.6	2.0	2.0	0.6	2.5	1.9	5.1	0.8	-1.6
Germany 1989	3.1	1.9	5.3	0.1	0.4	1.0	n.a.	n.a.	n.a.
Denmark 1983	1.4	2.6	3.4	3.1	0.0	-0.4	0.5	4.1	5.0
Denmark 1984	2.6	3.4	5.0	0.0	-0.4	2.5	4.1	5.0	6.7
Finland 1993	-4.5	-3.1	2.6	-2.3	-4.3	0.3	-9.7	-6.4	13.5
France 1996	1.7	2.0	0.9	0.0	2.6	1.2	0.8	6.9	8.3
UK 1997	3.6	4.2	2.6	1.7	0.0	1.5	2.1	5.6	11.2
UK 1998	4.2	2.6	2.2	0.0	1.5	3.0	5.6	11.2	2.4
Greece 1987	-1.4	2.8	5.9	-1.1	0.2	-5.5	5.8	-4.5	-0.3
Greece 1994	-0.8	2.0	2.7	2.6	-1.1	5.6	8.6	24.3	10.9
Greece 1996	2.7	1.9	2.5	5.6	1.0	-0.4	10.9	-1.91	3.4
Ireland 1987	2.9	3.3	4.4	2.6	-4.8	-5.0	6.8	3.6	12.1
Ireland 1988	3.3	4.4	5.9	-4.8	-5.0	-1.3	3.6	12.1	-10.0
Ireland 1989	4.4	5.9	0.6	-5.0	-1.3	5.4	12.1	-10.0	5.7
Italy 1983	1.1	0.6	2.5	2.5	3.1	2.1	12.0	3.7	0.8
Italy 1993	1.3	-3.4	0.9	1.2	0.5	-0.6	3.0	8.6	-4.9
Netherlands 1993	2.5	1.0	2.2	1.7	1.5	1.1	-4.5	6.4	-15.1
Netherlands 1996	2.0	2.7	3.0	0.3	1.2	1.5	-4.5	7.1	0.1
Portugal 1986	0.7	5.6	5.3	6.4	7.2	3.8	2.0	-20.7	-12.5
Portugal 1988	5.3	6.9	2.6	3.8	8.6	6.6	-12.5	32.3	23.2
Sweden 1983	0.7	-2.0	1.5	1.0	0.8	2.2	2.1	4.9	-0.5
Sweden 1987	4.4	4.6	2.4	1.3	1.0	0.6	6.5	11.1	5.8

Source: own calculations based on OECD (2005a) and European Commission (1999 and 2005).

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